FISCAL CHALLENGES AND THE ECONOMY IN THE LONG TERM

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WEDNESDAY, FEBRUARY 28, 2007

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:00 a.m., in room 210, Cannon House Office Building, Hon. John M. Spratt, Jr. (Chairman of the committee) presiding.

The Committee met, pursuant to call, at 10:00 p.m., in room 210, Cannon House Office Building, Hon. John M. Spratt, Jr. (Chairman of the committee) presiding.

Present: Representatives Spratt, Cooper, Allen, Schwartz, Kaptur, Becerra, Doggett, Blumenaur, Berry, McGovern, Andrews, Scott, Etheridge, Hooley, Moore, Bishop, Ryan, Barrett, Bonner, Garrett, Hensarling, McHenry, Campbell Tiberi, Alexander, Smith.

Chairman SPRATT. The hearing will come to order.

I am pleased today to welcome the Federal Reserve Chairman, Dr. Ben Bernanke, to the first appearance he has made before the House Budget Committee for a hearing on fiscal challenges and the economy over the long term.

I am pleased for many reasons not least of which is the fact that Dr. Bernanke is from Dillon, South Carolina, which is in my congressional district.

So I claim among other things the value of having his presence here today but also the bragging rights for what he has accomplished at the Fed where over a year's time, he has won high marks for his short hand at the helm.

Despite historically high budget deficits, interest rates and inflation are relatively low and our economy has been growing at a fairly good clip or healthy pace even if that rate has been slowing down recently.

Six years ago, we were in surplus. Our budget was in surplus and black for the first time in 30 years, not just in the year 2000, but in 1998 and 1999 as well. As a result, the federal government paid down nearly $400 billion of debt held by the public.

And President Bush came to office with an advantage that few Presidents have enjoyed, a budget in balance and surplus by $236 billion a year before he took office and in balance that year, 2000, without including the Social Security Trust Fund.

As a consequence, a number of members took up a new idea that had a corny name, lock box, but has a serious substantive core to it. Basically the idea was that we would quit using the Social Secu-

rity surplus to buy up new Treasury debt and instead use it to buy down outstanding Treasury debt.

The idea was that if we pursued this policy diligently, religiously, by 2020 or thereabouts, when 77 million baby boomers begin claiming their Social Security and Medicare benefits, Treasury would be less encumbered by public debt, more solvent, and thus better able to meet the claims of the baby boomers.

And by buying down existing Treasury debt, we would add to national savings, roll the cost of capital, and make the economy more productive and free us from dependence on foreign capital.

After all, one way to make entitlements more affordable, this will make our people more productive, and that was part of the idea behind the so-called lock box.

We said to the President when he began to unveil his proposal, which took a different turn and he was relying upon projected surpluses of $5.6 trillion, that while we may be sitting on an island of surpluses, we were surrounded by a sea of debt, long-term debt, and that should be taken into account now that we have the wherewithal to begin doing something about the problem.

The President, however, took a different path. He proposed a budget that over time included tax cuts close to $2 trillion. The numbers that were projected in 2001 did not obtain. They were seriously wide of the mark.

And so six years and $3 trillion in debt later, we find ourselves on a path that is described everywhere as unsustainable, deficit down a bit, down to $248 billion last year. That is good news.

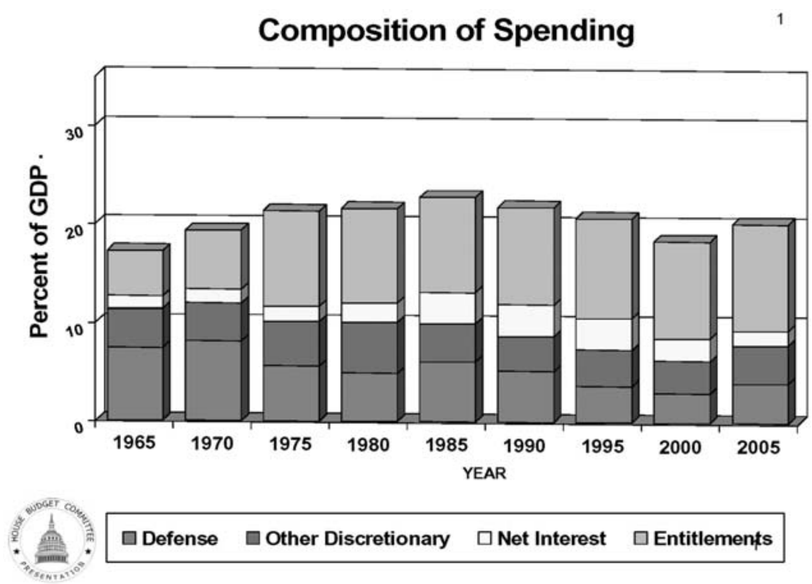
But, Dr. Bernanke, you warn in your testimony that this could very well be the lull before the storm. We are glad to have you here today to help us understand the perils of the path we are now taking and how we can employ the federal budget, which constitutes 20 percent of our GDP, to shore up our shortfall in savings and to move our economy and our country back towards long-term solvency.

We look forward to your testimony, and we appreciate your coming today.

Before turning to you for your statement, though, I would like to recognize Mr. Ryan, our Ranking Member, for a statement of his own.

Mr. RYAN. I thank the Chairman for yielding, and I am pleased to have Chairman Bernanke here today. It is nice to have you with us.

I just wanted to quickly go on the area where the Chairman went to. If you could call up chart one, please.



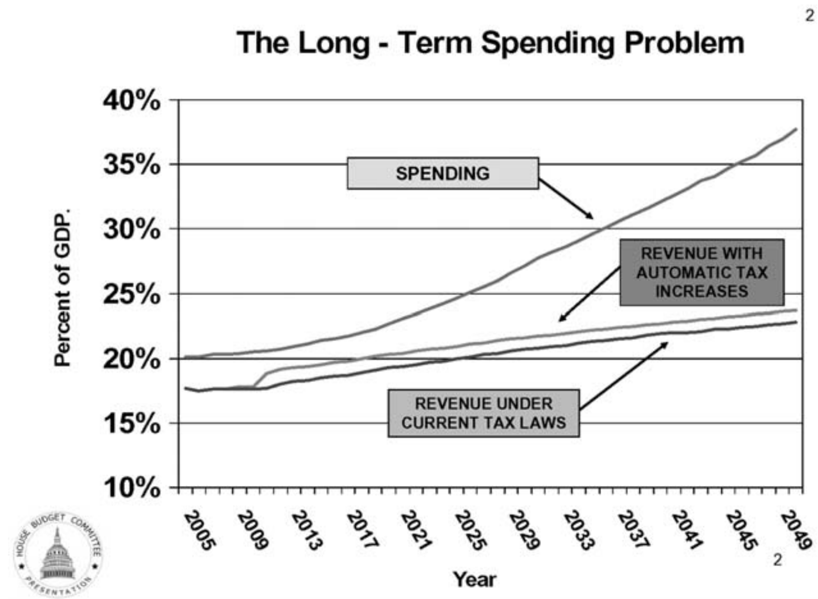
Mr. RYAN. We are here to discuss in the Budget Committee how we balance the budget, and that is a very important and worthy goal. But if we simply just balance the budget without addressing the underlying fundamentals of our budget issues, it will be a temporary thing. If we do not balance the budget without actually addressing the systemic spending problems underneath our budget, that is the problem that we are experiencing.

If you take a look at entitlement spending under the Bush Administration, under the Clinton Administration, under Republican Presidents, Democrat Presidents, Republican Congresses, Democratic Congresses, we have had this problem in front of us for quite some time.

As you can see, all other spending is getting crowded out and we are piling on interest and entitlement spending. And we are going to hear a lot of talk about the tax cuts as perhaps the route to fix and balance the budget.

But if we balance the budget without addressing the underlying, unsustainable growth rates of entitlement spending, we will only balance the budget temporarily and go quickly back into deficits because of the growth of entitlements.

If you go to chart two, please.



Mr. RYAN. This chart, I think, does a good job of illustrating the situation we have in front of us. This looks at spending in relation to tax revenues, which shows us in two ways.

First, if we keep the current tax laws in place just as they are, current tax rates, current child tax credit, current marriage penalty relief, and so on, that is the lower line, the blue line.

If we allow all those tax cuts to go away at the end of the decade as they are scheduled to expire, meaning a tax hike of $153 billion in 2011, tax hike of $254 billion in 2012, and larger amounts thereon after, that is the red line. These automatic tax increases are insumed in CBO's current law baseline.

Notice that either way, with or without the tax cuts, making them permanent or allowing them to expire, they do not come anywhere close to balancing the budget over the long run. They are quickly outpaced by the spending that we are on auto pilot right now with our entitlement programs.

So clearly what we face is an immense problem of spending. This is the problem right at hand right now and it is not going away.

Members of both sides of the aisle are going to debate about how just to accomplish and address these challenges. But I think it is very important that as we look at the performance of our economy, as we look at whether or not high tax rates on capital, high tax rates on families and businesses is the right way to go to a balanced budget or not, even if we go down the route of letting all the tax cuts expire, it does not come anywhere close to solving our fiscal problems, which is unsustainable entitlements.

And that is the issue that I think we ought to be addressing, and that is the issue I would love to get your opinions on, Chairman Bernanke.

Also, I will just simply say we had an interesting day in the stock market yesterday with the precipitous drop. I know all of us

are very concerned about that, and I think we would love to get your reflections should you care to share them with us on that point as well.

And with that, I would like to yield back the balance of my time. Thank you, Chairman.

Chairman SPRATT. Thank you, Mr. Ryan.

Dr. Bernanke, thank you again for coming.

Before proceeding, let me ask unanimous consent that all members be allowed to submit an opening statement for the record at this point.

In addition, Dr. Bernanke, we will be glad to make your statement a part of the record so that you can summarize parts of it if you please.

The floor is yours. Thank you again for coming.

STATEMENT OF BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Thank you.

Chairman Spratt, Representative Ryan, and other members of the Committee, I am pleased to be here to offer my views on the federal budget and related issues.

At the outset, I should underscore that I speak only for myself and not for my colleagues necessarily at the Federal Reserve.

My testimony will focus on the long-term budget outlook and will draw on the most recent set of long-term projections from the Congressional Budget Office issued in December 2005.

The CBO constructed its projections based on the assumptions that real gross domestic product would rise about three and a half percent per year in 2005 and 2006 and at the rate of 2.9 percent per anum from 2007 to 2015.

The growth projections through 2015 were in turn based on the assumptions that trend labor force growth will average 0.8 percent per year and that trend labor productivity growth in the nonforeign business sector will average 2.4 percent per year.

The CBO has since updated those assumptions for the purposes of other analyses, but the revisions were not large enough to materially alter the broad contours of the fiscal outlook.

As to the longer-term outlook, the CBO assumed that the growth rate of real GDP will average about two percent per year starting around 2020. While such projections are subject to considerable uncertainty, the CBO's assumptions provide a sensible and useful starting point for assessing the budget situation over the long run.

Before discussing the longer-run outlook, I will comment on recent budget developments. As you know, the deficit in the unified federal budget declined for a second year in fiscal year 2006, falling to $248 billion from $318 billion in fiscal 2005.

So far in fiscal 2007, solid growth in receipts, especially in collections of personal and corporate income taxes, has held the deficit somewhat below year earlier levels. Of course, a good deal of uncertainty still surrounds the budget outcome for the year as a whole.

Federal government outlays in fiscal 2006 were 20.3 percent of nominal gross domestic product. Receipts were 18.4 percent of GDP and the deficit, the difference of the two, was 1.9 percent of GDP. These percentages are close to their averages since 1960.

The on budget deficit, which differs from the unified budget deficit, primarily and excluding receipts and payments of the Social Security system, was $434 billion or 3.3 percent of GDP in fiscal 2006.

As of the end of fiscal 2006, federal government debt held by the public, which includes holdings by the Federal Reserve, but excludes those by the Social Security and other trust funds, amounted to 37 percent of one year's GDP.

Official projections suggest that the unified budget deficit may stabilize or moderate further over the next few years. Unfortunately, we are experiencing what seems likely to be the calm before the storm. In particular, spending on entitlement programs will begin to climb quickly during the next decade.

In fiscal 2006, federal spending for Social Security, Medicare, and Medicaid together totaled about 40 percent of federal expenditures or eight and a half percent of GDP.

In the medium-term projections released by the CBO in January, these outlays increase to ten and three-quarters percent of GDP by 2017, an increase of about two percentage points of GDP in little more than a decade. And they will likely continue to rise sharply relative to GDP in the years after that.

As I will discuss, these rising entitlement obligations will put enormous pressure on the federal budget in coming years.

The large projected increases in future entitlement spending have two principal sources. First, like many other industrial countries, the United States has entered what is likely to be a long period of demographic transition. The result, both of the reduction in fertility that followed the post World War II baby boom and of ongoing increases in life expectancy.

Longer life expectancies are certainly to be welcomed, but they are likely to lead to longer periods of retirement in the future even as the growth rate of the workforce declines.

As a consequence of these demographic trends, the number of people of retirement age will grow relative both to the population as a whole and to the number of potential workers.

Currently people 65 years and older make up about 12 percent of the U.S. population, and there are about five people between the ages of 20 and 65 for each person 65 and older.

According to the intermediate projections of the Social Security Trustees, in 2030, Americans 65 and older will constitute about 19 percent of the U.S. population and the ratio of those between the ages of 20 and 64 to those 65 and older will have fallen to about three.

Although the retirement of the baby boomers will be an important milestone in the demographic transition, the oldest baby boomers will be eligible for Social Security benefits starting next year.

The change in the nation's demographic structure is not just a temporary phenomenon related to the large relative size of the baby boom generation. Rather, if the U.S. fertility rate remains close to current levels and life expectancies continue to rise as demographers generally expect, the U.S. population will continue to grow older even after the baby boom generation has passed from the scene.

If current law is maintained, that aging of the U.S. population will lead to sustained increases in federal entitlement spending on programs that benefit older Americans, such as Social Security and Medicare.

The second cause of rising entitlement spending is the expected continued increase in medical costs per beneficiary. Projections of future medical costs are fraught with uncertainty. But history suggests that without significant changes in policy, these costs are likely to continue to rise more quickly than incomes, at least for the foreseeable future.

Together with the aging of the population, ongoing increases in medical costs will lead to a rapid expansion of Medicare and Medicaid expenditures.

Long-range projections prepared by the CBO vividly portray the potential effects on the budget of an aging population and rapidly rising healthcare costs.

The CBO has developed projections for a variety of alternative scenarios based on different assumptions about the evolution of spending and taxes. The scenarios produce a wide range of possible budget outcomes reflecting the substantial uncertainty that attends long-range budget projections.

However, the outcomes that appear most likely in the absence of policy changes involve rising budget deficits and increases in the amount of federal debt outstanding to unprecedented levels.

For example, one plausible scenario is based on the assumptions that federal retirement and health spending will follow the CBO's intermediate projection, defense spending will drift down over time as a percentage of GDP, other noninterest spending will grow roughly in line with GDP, and federal revenues will remain close to their historical share of GDP, that is about where they are today.

Under these assumptions, the CBO calculates that by 2030, the federal budget deficit will approach nine percent of GDP, more than four times greater as a share of GDP than the deficit in the fiscal year 2006.

A particularly worrisome aspect of this projection and similar ones is the implied evolution of the national debt and the associated interest payments to government bond holders.

Minor details aside, the federal debt held by the public increases each year by the amount of that year's unified deficit. Consequently, scenarios that project large deficits also project rapid growth in the outstanding government debt.

The higher levels of debt in turn imply increased expenditures on interest payments to bond holders which exacerbate the deficit problem still further.

Thus, a vicious cycle may develop in which large deficits lead to rapid growth in debt and interest payments which in turn adds to the subsequent deficits.

According to the CBO projection that I have been discussing, interest payments on the government's debt will reach four and a half percent of GDP in 2013, nearly three times their current size relative to national output.

Under this scenario, the ratio of federal debt held by the public to GDP would climb from 37 percent to roughly 100 percent in 2030 and would continue to grow exponentially after that.

The only time in U.S. history that the debt to GDP ratio has been in the neighborhood of 100 percent was during World War II. People at that time understood the situation to be temporary and expected deficits and the debt to GDP ratio to fall rapidly after the war as, in fact, they did.

In contrast, under the scenario I have been discussing, the debt to GDP ratio would rise far into the future at an accelerating rate. Ultimately this expansion of debt would spark a fiscal crisis which could be addressed only by very sharp spending cuts or tax increases or both.

The CBO projections by design ignore the adverse effects that such high deficits would likely have on economic growth. But if government debt and deficits were actually to grow at the pace envisioned by the CBO's scenario, the effects on the U.S. economy would be severe.

High rates of government borrowing would drain funds away from capital formation and thus slow the growth of real incomes and living standards over time.

Some fraction of the additional debt that would likely be financed abroad would lessen the negative influence on domestic investment. However, the necessity of paying interest on the foreign held debt would leave a smaller portion of our nature's future output available for domestic consumption.

Moreover, uncertainty about the ultimate resolution of the fiscal imbalances would reduce the confidence of consumers, businesses, and investors in the U.S. economy with adverse implications for investment and growth.

To some extent, strong economic growth can help to mitigate budgetary pressures and all else being equal, fiscal policies that are supportive of growth would be beneficial.

Unfortunately, economic growth alone is unlikely to solve the nation's impending fiscal problems. Economic growth leads to higher wages and profits and thus increases in tax receipts. But higher wages also imply increased Social Security benefits as those benefits are tied to wages.

Higher incomes also tend to increase the demand for medical services so that indirectly higher incomes may also increase federal health expenditures.

Increased rates of immigration could raise growth by raising the growth rate of the labor force. However, economists who have looked at the issue have found that even a doubling in the rate of immigration into the United States from about one million to two million immigrants per year would not significantly reduce the federal government's fiscal imbalance.

The prospect of growing fiscal imbalances and their economic consequences also raises essential questions of intergenerational fairness. As I have noted, because of increasing life expectancy and the decline in fertility, the number of retirees that each worker will have to support in the future, either directly or indirectly, through taxes paid to support government programs will rise significantly.

To the extent that federal budgetary policies inhibit capital formation and our increases net liabilities to foreigners, future generations of Americans will bear a growing burden of the debt and experience slower growth in per capita incomes than would otherwise have been the case.

An important element in ensuring that we leave behind a stronger economy than we inherited as in virtually all previous generations in this country will be to move over time towards fiscal policies that are sustainable, efficient, and equitable across generations.

Policies that promote private as well as public saving would also help us to leave a productive economy to our children and grandchildren. In addition, we should explore ways to make the labor market as accommodating as possible to older people who wish to continue working as many will as longevity increases and health improves.

Addressing the country's fiscal problems will take persistence and a willingness to make difficult choices. In the end, the fundamental decision that the Congress, the Administration, and the American people must confront is how large a share of the nation's economic resources to devote to federal government programs, including transfer programs, such as Social Security, Medicare, and Medicaid.

Crucially, whatever size of the government is chosen, tax rates must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run.

Thus, members of the Congress who put special emphasis on keeping tax rates low must accept that low tax rates can be sustained only if outlays, including those and entitlements, are kept low as well.

Likewise, members who favor a more expansive role of the government, including relatively more generous benefits payments, must recognize the burden imposed by the additional taxes needed to pay for the higher spending, a burden that includes not only the resources transferred from the private sector but also any adverse economic incentives associated with higher tax rates.

Achieving fiscal sustainability will require sustained efforts and attention over many years. As an aid in charting the way forward, the Congress may find it useful to set some benchmarks against which to gauge progress towards key budgetary objectives.

Because no single statistic fully describes the fiscal situation, the most effective approach would likely involve monitoring a number of fiscal indicators, each of which captures a different aspect of the budget and its economic impact.

The unified budget deficit projected forward a certain number of years is an important measure that is already included in the congressional budgeting process. However, the unified budget deficit does not fully capture the fiscal situation and its effect on the economy for at least two reasons.

First, the budget deficit by itself does not measure the quantity of resources that the government is taking from the private sector. An economy in which the government budget is balanced but in which government spending equals 20 percent of GDP is very different from one in which the government's budget is balanced but

its spending is 40 percent of GDP as the latter economy has both higher tax rates and a greater role for the government.

Monitoring current and prospective levels of total government outlays relative to GDP or a similar indicator would help the Congress to ensure that the overall size of the government relative to the economy is consistent with members' views and preferences.

Second, the annual budget deficit reflects only near-term financing needs and does not capture long-term fiscal imbalances. As the most difficult long-term budgetary issues are associated with the growth of entitlement spending, a comprehensive approach to budgeting would include close attention to measures of the long-term solvency of entitlement programs, such as long horizon present values of unfunded liabilities for Social Security and Medicare.

To summarize, because of demographic changes and rising medical costs, federal expenditures for entitlement programs are projected to rise sharply over the next few decades. Dealing with the resulting fiscal strains will pose difficult choices for the Congress, the Administration, and the American people.

However, if early and meaningful action is not taken, the U.S. economy could be seriously weakened with future generations bearing much of the cost.

The decisions the Congress will face will not be easy or simple, but the benefits of placing the budget on a path that is both sustainable and meets the nation's long-run needs would be substantial.

Thank you again for allowing me to comment on these important issues, and I would be glad to take your questions. Thank you again.

[The prepared statement of Ben S. Bernanke follows:]

PREPARED STATEMENT OF HON. BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chairman Spratt, Representative Ryan, and other members of the Committee, I am pleased to be here to offer my views on the federal budget and related issues. At the outset, I should underscore that I speak only for myself and not necessarily for my colleagues at the Federal Reserve.

My testimony will focus on the long-term budget outlook and will draw on the most recent set of long-term budget projections from the Congressional Budget Office (CBO), issued in December 2005. The CBO constructed its projections based on the assumptions that real gross domestic product (GDP) would rise about 3½ percent per year in 2005 and 2006 and at a rate of 2.9 per cent per annum from 2007 through 2015. The growth projections through 2015 were in turn based on the assumptions that trend labor force growth will average 0.8 percent per year and that trend labor productivity growth in the nonfarm business sector will average 2.4 percent per year. The CBO has since updated those assumptions for the purposes of other analyses, but the revisions were not large enough to materially alter the broad contours of the fiscal outlook.[1] As for the longer-term outlook, the CBO assumed that the growth rate of real GDP will average about 2 percent per year starting around 2020. While such projections are subject to considerable uncertainty, the CBO's assumptions provide a sensible and useful starting point for assessing the budget situation over the longer run.

Before discussing that longer-run outlook, I will comment on recent budget developments. As you know, the deficit in the unified federal budget declined for a second year in fiscal year 2006, falling to $248 billion from $318 billion in fiscal 2005. So far in fiscal 2007, solid growth in receipts, especially in collections of personal and corporate income taxes, has held the deficit somewhat below year-earlier levels. Of course, a good deal of uncertainty still surrounds the budget outcome for the year as a whole. Federal government outlays in fiscal 2006 were 20.3 percent of nominal gross domestic product (GDP), receipts were 18.4 percent of GDP, and the deficit (equal to the difference of the two) was 1.9 percent of GDP. These percentages are

close to their averages since 1960. The on-budget deficit, which differs from the unified budget deficit primarily in excluding receipts and payments of the Social Security system, was $434 billion, or 3.3 percent of GDP, in fiscal 2006.[2] As of the end of fiscal 2006, federal government debt held by the public, which includes holdings by the Federal Reserve but excludes those by the Social Security and other trust funds, amounted to 37 percent of one year's GDP.

Official projections suggest that the unified budget deficit may stabilize or moderate further over the next few years. Unfortunately, we are experiencing what seems likely to be the calm before the storm. In particular, spending on entitlement programs will begin to climb quickly during the next decade. In fiscal 2006, federal spending for Social Security, Medicare, and Medicaid together totaled about 40 percent of federal expenditures, or 8½ percent of GDP.[3] In the medium-term projections released by the CBO in January, these outlays increase to 10¾ percent of GDP by 2017, an increase of about 2 percentage points of GDP in little more than a decade, and they will likely continue to rise sharply relative to GDP in the years after that. As I will discuss, these rising entitlement obligations will put enormous pressure on the federal budget in coming years.

The large projected increases in future entitlement spending have two principal sources. First, like many other industrial countries, the United States has entered what is likely to be a long period of demographic transition, the result both of the reduction in fertility that followed the post-World War II baby boom and of ongoing increases in life expectancy. Longer life expectancies are certainly to be welcomed. But they are likely to lead to longer periods of retirement in the future, even as the growth rate of the workforce declines. As a consequence of the demographic trends, the number of people of retirement age will grow relative both to the population as a whole and to the number of potential workers. Currently, people 65 years and older make up about 12 percent of the U.S. population, and there are about five people between the ages of 20 and 64 for each person 65 and older. According to the intermediate projections of the Social Security Trustees, in 2030 Americans 65 and older will constitute about 19 percent of the U.S. population, and the ratio of those between the ages of 20 and 64 to those 65 and older will have fallen to about 3.

Although the retirement of the baby boomers will be an important milestone in the demographic transition—the oldest baby boomers will be eligible for Social Security benefits starting next year—the change in the nation's demographic structure is not just a temporary phenomenon related to the large relative size of the baby-boom generation. Rather, if the U.S. fertility rate remains close to current levels and life expectancies continue to rise, as demographers generally expect, the U.S. population will continue to grow older, even after the baby-boom generation has passed from the scene. If current law is maintained, that aging of the U.S. population will lead to sustained increases in federal entitlement spending on programs that benefit older Americans, such as Social Security and Medicare.

The second cause of rising entitlement spending is the expected continued increase in medical costs per beneficiary. Projections of future medical costs are fraught with uncertainty, but history suggests that—without significant changes in policy—these costs are likely to continue to rise more quickly than incomes, at least for the foreseeable future. Together with the aging of the population, ongoing increases in medical costs will lead to a rapid expansion of Medicare and Medicaid expenditures.

Long-range projections prepared by the CBO vividly portray the potential effects on the budget of an aging population and rapidly rising health care costs. The CBO has developed projections for a variety of alternative scenarios, based on different assumptions about the evolution of spending and taxes. The scenarios produce a wide range of possible budget outcomes, reflecting the substantial uncertainty that attends long-range budget projections.[4] However, the outcomes that appear most likely, in the absence of policy changes, involve rising budget deficits and increases in the amount of federal debt outstanding to unprecedented levels. For example, one plausible scenario is based on the assumptions that (1) federal retirement and health spending will follow the CBO's intermediate projection; (2) defense spending will drift down over time as a percentage of GDP; (3) other non-interest spending will grow roughly in line with GDP; and (4) federal revenues will remain close to their historical share of GDP—that is, about where they are today.[5] Under these assumptions, the CBO calculates that, by 2030, the federal budget deficit will approach 9 percent of GDP—more than four times greater as a share of GDP than the deficit in fiscal year 2006.

A particularly worrisome aspect of this projection and similar ones is the implied evolution of the national debt and the associated interest payments to government bondholders. Minor details aside, the federal debt held by the public increases each

year by the amount of that year's unified deficit. Consequently, scenarios that project large deficits also project rapid growth in the outstanding government debt. The higher levels of debt in turn imply increased expenditures on interest payments to bondholders, which exacerbate the deficit problem still further. Thus, a vicious cycle may develop in which large deficits lead to rapid growth in debt and interest payments, which in turn adds to subsequent deficits. According to the CBO projection that I have been discussing, interest payments on the government's debt will reach 4½ percent of GDP in 2030, nearly three times their current size relative to national output. Under this scenario, the ratio of federal debt held by the public to GDP would climb from 37 percent currently to roughly 100 percent in 2030 and would continue to grow exponentially after that. The only time in U.S. history that the debt-to-GDP ratio has been in the neighborhood of 100 percent was during World War II. People at that time understood the situation to be temporary and expected deficits and the debt-to-GDP ratio to fall rapidly after the war, as in fact they did. In contrast, under the scenario I have been discussing, the debt-to-GDP ratio would rise far into the future at an accelerating rate. Ultimately, this expansion of debt would spark a fiscal crisis, which could be addressed only by very sharp spending cuts or tax increases, or both.[6]

The CBO projections, by design, ignore the adverse effects that such high deficits would likely have on economic growth. But if government debt and deficits were actually to grow at the pace envisioned by the CBO's scenario, the effects on the U.S. economy would be severe. High rates of government borrowing would drain funds away from private capital formation and thus slow the growth of real incomes and living standards over time. Some fraction of the additional debt would likely be financed abroad, which would lessen the negative influence on domestic investment; however, the necessity of paying interest on the foreign-held debt would leave a smaller portion of our nation's future output available for domestic consumption. Moreover, uncertainty about the ultimate resolution of the fiscal imbalances would reduce the confidence of consumers, businesses, and investors in the U.S. economy, with adverse implications for investment and growth.

To some extent, strong economic growth can help to mitigate budgetary pressures, and all else being equal, fiscal policies that are supportive of growth would be beneficial. Unfortunately, economic growth alone is unlikely to solve the nation's impending fiscal problems. Economic growth leads to higher wages and profits and thus increases tax receipts, but higher wages also imply increased Social Security benefits, as those benefits are tied to wages. Higher incomes also tend to increase the demand for medical services so that, indirectly, higher incomes may also increase federal health expenditures. Increased rates of immigration could raise growth by raising the growth rate of the labor force. However, economists who have looked at the issue have found that even a doubling in the rate of immigration to the United States, from about 1 million to 2 million immigrants per year, would not significantly reduce the federal government's fiscal imbalance.[7]

The prospect of growing fiscal imbalances and their economic consequences also raises essential questions of intergenerational fairness.[8] As I have noted, because of increasing life expectancy and the decline in fertility, the number of retirees that each worker will have to support in the future—either directly or indirectly through taxes paid to support government programs—will rise significantly. To the extent that federal budgetary policies inhibit capital formation and increase our net liabilities to foreigners, future generations of Americans will bear a growing burden of the debt and experience slower growth in per-capita incomes than would otherwise have been the case.

An important element in ensuring that we leave behind a stronger economy than we inherited, as did virtually all previous generations in this country, will be to move over time toward fiscal policies that are sustainable, efficient, and equitable across generations. Policies that promote private as well as public saving would also help us leave a more productive economy to our children and grandchildren. In addition, we should explore ways to make the labor market as accommodating as possible to older people who wish to continue working, as many will as longevity increases and health improves.

Addressing the country's fiscal problems will take persistence and a willingness to make difficult choices. In the end, the fundamental decision that the Congress, the Administration, and the American people must confront is how large a share of the nation's economic resources to devote to federal government programs, including transfer programs such as Social Security, Medicare, and Medicaid. Crucially, whatever size of government is chosen, tax rates must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run. Thus, members of the Congress who put special emphasis on keeping tax rates low must accept that low tax rates can be sustained only if outlays, including those

on entitlements, are kept low as well. Likewise, members who favor a more expansive role of the government, including relatively more-generous benefits payments, must recognize the burden imposed by the additional taxes needed to pay for the higher spending, a burden that includes not only the resources transferred from the private sector but also any adverse economic incentives associated with higher tax rates.

Achieving fiscal sustainability will require sustained efforts and attention over many years. As an aid in charting the way forward, the Congress may find it useful to set some benchmarks against which to gauge progress toward key budgetary objectives. Because no single statistic fully describes the fiscal situation, the most effective approach would likely involve monitoring a number of fiscal indicators, each of which captures a different aspect of the budget and its economic impact. The unified budget deficit, projected forward a certain number of years, is an important measure that is already included in the congressional budgeting process. However, the unified budget deficit does not fully capture the fiscal situation and its effect on the economy, for at least two reasons.

First, the budget deficit by itself does not measure the quantity of resources that the government is taking from the private sector. An economy in which the government budget is balanced but in which government spending equals 20 percent of GDP is very different from one in which the government's budget is balanced but its spending is 40 percent of GDP, as the latter economy has both higher tax rates and a greater role for the government. Monitoring current and prospective levels of total government outlays relative to GDP or a similar indicator would help the Congress ensure that the overall size of the government relative to the economy is consistent with members' views and preferences.

Second, the annual budget deficit reflects only near-term financing needs and does not capture long-term fiscal imbalances. As the most difficult long-term budgetary issues are associated with the growth of entitlement spending, a comprehensive approach to budgeting would include close attention to measures of the long-term solvency of entitlement programs, such as long-horizon present values of unfunded liabilities for Social Security and Medicare.

To summarize, because of demographic changes and rising medical costs, federal expenditures for entitlement programs are projected to rise sharply over the next few decades. Dealing with the resulting fiscal strains will pose difficult choices for the Congress, the Administration, and the American people. However, if early and meaningful action is not taken, the U.S. economy could be seriously weakened, with future generations bearing much of the cost. The decisions the Congress will face will not be easy or simple, but the benefits of placing the budget on a path that is both sustainable and meets the nation's long-run needs would be substantial.

Thank you again for allowing me to comment on these important issues. I would be glad to take your questions.

ENDNOTES

[1] According to the latest estimates of the Bureau of Economic Analysis (BEA), real GDP growth was 3.2 percent in 2005 and 3.4 percent in 2006, both figures stated on an annual-average basis. The figure for 2006 is the BEA's "advance" estimate; a revised estimate is scheduled for release today.

[2] Excluding the operations of both Social Security and Medicare Part A, the budget deficit in fiscal year 2006 was $459 billion, or 3.5 percent of GDP. Like Social Security, Medicare Part A pays benefits out of, and receives a dedicated stream of revenues into, a trust fund.

[3] Net of Medicare premiums paid by beneficiaries and amounts paid by states from savings on Medicaid prescription drug costs, these outlays were equal to 8 percent of GDP.

[4] For example, in 2030, five of the six scenarios imply deficits ranging from 1½ percent of GDP to nearly 14 percent of GDP; a sixth scenario is capable of producing a surplus, but it relies on the confluence of a very favorable set of assumptions.

[5] For more information about this scenario, see the description of Scenario 2 in Congressional Budget Office (2005), The Long-Term Budget Outlook, December, pp. 5-13 and 48-49, *www.cbo.gov/ftpdocs/69xx/doc6982/12-15-LongTermOutlook.pdf.* Consistent with the assumptions used by the Medicare trustees, the CBO's intermediate projections for Medicare and Medicaid are based on the assumption that, over the long run, per beneficiary health expenditures will increase at a rate that is 1 percentage point per year greater than the growth rate of per capita GDP. Over the past twenty-five years, however, per beneficiary Medicare spending has actually exceeded per capita GDP growth by about 2½ percentage points per year. Thus, a significant slowing in the growth of medical costs per beneficiary will be needed to keep expenditures close to those projected in this scenario.

[6] To give a sense of the magnitudes involved, suppose—for the sake of illustration only—that the deficit projected for 2030 in the CBO scenario were to be eliminated entirely in that year, half through reductions in discretionary spending and half through increases in non-payroll taxes. (Of course, in reality the fiscal adjustment would likely not occur in one year, but this hypothetical example is useful for showing the magnitude of the problem.) This fiscal adjustment would involve a cut in discretionary spending (including defense) of nearly 80 percent (rel-

ative to its baseline level) and a rise in non-payroll taxes of more than 35 percent. The need for such painful measures could be diminished by beginning the process of fiscal adjustment much earlier, thereby avoiding some of the buildup in outstanding debt and the associated interest burden.

[7] CBO (2005), The Long-Term Budget Outlook, p. 3.

[8] I discussed this issue in Ben S. Bernanke (2006), "The Coming Demographic Transition: Will We Treat Future Generations Fairly?", speech delivered before the Washington Economic Club, Washington, October 4, *www.federalreserve.gov/boarddocs/speeches/2006/20061004/default.htm.*

Chairman SPRATT. Dr. Bernanke, you will receive questions on this subject anyway, so I will give you the opportunity to take the first pitch.

Yesterday, we had severe disruption in the stock markets. Would you care to make any statement or reflection upon what happened yesterday and whether or not it has any connection to our fiscal situation?

Mr. BERNANKE. There did not seem to be any single trigger of the market correction we saw yesterday. I do not think it would be useful for me to try to parse the movement into the components associated with different pieces of news or pieces of information.

I will say that the Federal Reserve in collaboration with the President's Working Group has been closely monitoring the markets. They seem to be working well and normally.

We have also, of course, been closely monitoring the economy, looking at new data and trying to evaluate their implications for the forecast.

And my view is that taking all the new data into account that there is really no material change in our expectations for the U.S. economy since I last reported to Congress a couple weeks ago in the Humphrey Hawkins hearings.

Chairman SPRATT. Do you expect the growth rate in the economy to decline slightly?

Mr. BERNANKE. We are looking for moderate growth in the U.S. economy going forward. And I would add parenthetically that the downward revision of the fourth quarter GDP numbers we got this morning is actually more consistent with our overall view of the economy than were the original numbers.

So we expect moderate growth going forward. We believe that if the housing sector begins to stabilize and if some of the inventory corrections are still going on and manufacturing begins to be completed that there is a reasonable possibility that we will see some strengthening of the economy sometime during the middle of the year.

Chairman SPRATT. Turning now to a different topic. We have difficulty explaining to the American public why the deficit is such a serious matter. You just touched upon and every eloquently touched upon the intergenerational equity aspects of the problem.

But we do not see or feel the effects of it now, and that is even more true for the long-term debt, which is substantial. When it is discounted back to present value, you can understand it in those terms. But, nevertheless, we do not see the consequences of it.

Traditionally it was believed that the federal government would, by running large deficits, crowd out private borrowers in the credit markets and run up interest rates. We have not seen any unusual increase in relative interest rates, and that appears to be a result of the fact that we are financing a lot of our debt with foreigners.

Is that a correct perception and, if so, what are the consequences of being reliant for financing the federal government on foreign capital markets?

Mr. BERNANKE. Mr. Chairman, in the short run, budget deficits tend to reduce national saving. And that leads to two possible outcomes. One is that domestic investment will fall accordingly along with saving. The other possibility is that investment will be maintained, but in order to finance that investment, we have to borrow essentially abroad, which results in a large current account deficit.

In recent years, it seems more of the latter has been happening. We have been borrowing abroad to finance domestic investment, and so we have seen not a very significant increase in real interest rates. In fact, real interest rates are generally low around the world.

But what we have seen on the other side of the equation, we have seen large increases in our foreign debt and in our current account deficit.

Looking forward to the longer run, I guess the analogy I would make here is that this is sort of like a snowball rolling down the hill. It is already a pretty big snowball, but it is going to get a lot bigger a lot faster, and we have an opportunity now to try and prevent that cumulative process that will go on if we do not take some action.

In particular, because deficits feed into debt which feed into deficits, this could really get out of control over a long period of time, and it would have very significant consequences for capital formation and for foreign debt and for the financial security of Americans, particularly the next generation who will be saddled with this growing debt.

So it is a very significant problem. The real consequences will be felt to a greater degree over time and more so a few years from now than today, but it is that very fact that we have the opportunity to move today that we can perhaps put ourselves on a better path and avoid what would have to be much more severe and draconian responses ten, fifteen, or twenty years down the road.

Chairman SPRATT. One reason we resort to foreign borrowing is that we have at the present time a dismally, abysmally low savings rate ourselves in the United States.

What do you think we should do to improve to shore up the savings rate in the United States?

Mr. BERNANKE. Well, that is a challenging question. Certainly improving budget balance both at the federal and, to some extent also, of course, at the state and local levels.

Chairman SPRATT. Because that by itself is dis-saving. If you correct that, that in itself——

Mr. BERNANKE. That is correct.

Chairman SPRATT [continuing]. Corrects part of the problem.

Mr. BERNANKE. So the borrowing to finance deficits, if you think of it is as being taken out of the pool of saving done by the private sector, leaving less left over for capital investment. So one way to add to national saving is to try to reduce deficits as much as possible.

The other is, of course, to try and increase saving in the private sector. And we have in our country relatively low, in fact currently negative, household saving rates.

There is quite a debate among economists about how best to increase those saving rates. I would just point to one direction that was included in the recent pension bill that the Congress passed and the President signed which is to allow opt out 401k programs among employers.

We have a lot of evidence that people, if they are required to opt out of a savings program, that the inertia will win out and they will save more. And that is really one of the ways in which we probably could increase saving at the private level.

Beyond that, there are a number of possibilities, including tax policies, including financial literacy and others, which I can discuss in more detail. I am sure there will be questions. But we do not really have a silver bullet for household saving, and we should, I think, though, try to encourage it as much as possible.

Chairman SPRATT. One final question from me. You made a speech recently in which you addressed a concern. To some extent, you touched upon it today when you discussed the intergenerational equity of deficits. You were concerned about the disparities in income in our economy.

To what extent is this a problem for the economy itself, for the country, and what would you recommend that we do about that? Are you recommending more progressive tax policies or——

Mr. BERNANKE. Mr. Chairman——

Chairman SPRATT [continuing]. What do we need to do to address that problem, and how severe is the problem in your estimation?

Mr. BERNANKE. Mr. Chairman, this is not a new issue. We have seen increasing income inequality in the United States for at least three decades and, according to some measures, maybe four or five decades.

In my speech, I discussed a number of possible sources of that increase in inequality. I think one of the most important is technology which is increasing the returns to higher education. So people who have more education or greater skills are seeing much higher incomes relative to those with less education and lower skills. And that is generating greater inequality in the economy.

I think this is an important problem both because we do not want to see excessive inequality and we do not want to see people at the lower end of the ladder not enjoying, you know, some of the benefits of our economic growth.

I think it is also a problem because in order to continue to grow, we need to have public buy-in to a continued open and flexible economy. And I am afraid that if people begin to feel that the economy is not benefiting them, then they will, you know, resist the flexibility and dynamism that is so important to our economic growth.

I think the most likely approach for arresting this trend, the most beneficial approach would be to strengthen our educational and training systems as much as possible and to encourage people to get the skills they need to earn higher incomes.

Chairman SPRATT. Thank you very much.

Mr. Ryan.

Mr. RYAN. Thank you, Mr. Chairman and Mr. Chairman.

Some people believe that yesterday's market corrections are due to a liquidity crunch and they compare it to the corrections in 1987 and 1998.

Do you believe or agree that there is a liquidity problem in the world today?

Mr. BERNANKE. No, I do not think so.

Mr. RYAN. Some also have been pointing to a concern about subprime lending. And just yesterday, Freddie Mac said that it would tighten its lending standards.

It seems to some of us that this is a small part of the market and unlikely to cause major problems, but I would be curious about your take on that.

Mr. BERNANKE. There certainly have been some concerns raised about the health of the subprime sector. We have seen increasing rate of default. We have seen financial distress on the part of lenders. And so that is a concern.

We are monitoring that situation very carefully, and it was one of the factors, I think, which has contributed to some unease about the economy, about the market.

Our assessment, though, while this is a very important problem and an issue obviously for many people who are facing foreclosure, our assessment is that there is not much indication at this point that subprime mortgage issues have spread into the broader mortgage market, which still seems to be healthy, and the lending side of that still seems to be healthy.

So it is a concern. But at this point, we do not see it as being a broad financial concern or a major factor in assessing the course of the economy.

Mr. RYAN. I want to ask a question about sort of fed governance. For the 1960s and the 1970s, the fed and central banks around the world really sort of used a Phillip's curve to dictate monetary policy. And it seems that the evidence, which obviously is lagging and takes a while to build up, has come in and has more or less clearly debunked the Phillip's curve as a primary driver of monetary policy. And there seems to be a growing body of evidence that unemployment and inflation are not nearly as linked as the Phillip's curve would suggest.

Do you agree with that, and do you believe that commodity prices are a better indicator of inflation and of inflationary expectations?

Mr. BERNANKE. It is true that the empirical evidence suggests that the link is looser, that there is less responsiveness of inflation to employment conditions than there perhaps may have been in past decades.

My own view is that we should take a very eclectic approach in thinking about inflation. I look at the state of the economy and try to assess whether demand is exceeding supply in some sense, whether the financial conditions are promoting growth and demand which is greater than the productive capacity of the economy. But I also look at a wide variety of indicators including commodity prices, including financial indicators like bond rates and inflation compensation.

I do not think we can rely on any single indicator, particularly one like the natural rate of unemployment concept. It is very difficult to know if—even if there is such a relationship, it is very difficult to assess in real time where that number might be.

And so we really have no alternative but to look at, you know, many indicators, including the one you mentioned, to try to assess where inflation is going.

Mr. RYAN. In the past in your academic career, you seem to be a fan of inflation targeting. We have seen other countries, obviously much smaller economies, test inflation targeting with some great degrees of success, it seems.

What is your current impression of inflation targeting?

Mr. BERNANKE. Well, I should say that I view inflation objectives and the like as being part of the communication tool kit that a central bank may have to try to explain to the markets and to the public what its approach is, what its plans are, and how it sees the economy.

We are currently in the Federal Open Market Committee conducting a zero-based review of our communications policies, looking at, among them, numerical objectives for inflation, but many other approaches as well, to try to provide more information to the public about our plans and our approach.

So in terms of the specifics, I think I would leave that open because our Committee has not yet decided, you know, what approaches we want to take.

The one thing I would say is that there is certainly a strong conviction that maintaining low and stable inflation is not—this goes back to the first part of your question—is not something that reduces employment and growth. To the contrary, an economy that has low and stable inflation is going to grow faster and have more stability than one in which inflation is high and unstable. We learned that in the 1970s and it has become increasingly evident in the last couple of decades.

So whether or not we have an explicit target or not, it is very important for the Federal Reserve to maintain low and stable inflation.

Mr. RYAN. I totally agree with that. I would just simply encourage, and I have one quick last question.

As you continue these deliberations on your communications toolbox, that the more explicit expectations that the market can see, the better and more stable the market horizon and investment horizons are for investors and for the economy. So to the extent that you can be more explicit about that, that is all to the good, I think.

One last final question. There is going to be a lot of talk this year about whether or not to raise taxes. And you are seeing a lot of speculation as to whether or not Congress is going to affirmatively allow some tax cuts to expire, such as the growth tax cuts, dividends, cap gains, top marginal income tax rates, things like that.

Is there a chance that this discussion itself could have a negative impact on the market? And we have also had surging revenues. Would you care to comment on that as well?

And then I yield.

Mr. BERNANKE. Congressman, as you know, the Federal Reserve is nonpartisan. And I talk about many, many issues. I realize some

of them are very broad. But I do think it is important for me, and this is something that is going to be relevant to today's discussion, I think it is important for me not to implicitly or explicitly endorse any spending or tax program for or against.

So I hope you will understand if I do not make an assessment of that.

Mr. RYAN. All right. Thank you.

Chairman SPRATT. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

And thank you, Chairman Bernanke, for your excellent testimony.

On page nine, you say, "A comprehensive approach to budgeting would include close attention to measures of the long-term solvency of entitlement programs, such as the long horizon present values of unfunded liabilities for Social Security and Medicare."

Last year, this Committee passed unanimously—in fact, it was the only unanimous thing the Committee did—my amendment that would encourage us to look not only at the unified budget deficit but also at, for example, accrual measures of our fiscal position so that we would have better perspective on where we are. So this Committee has been trying to focus on a broader set of measures.

It worries me, though, that we are in the situation of the average American who does not know they have high blood sugar levels, which means possible diabetes, because in this country, there is sadly, tragically for many people, a seven-year delay between onset of high blood sugar and then actual diagnosis of the disease, because, as Chairman Spratt noted, there are no symptoms. You cannot tell that you have high blood sugar.

The average American just looking at the unified budget deficit cannot tell we have got a major problem. That is why we need broader measures, so that we might be encouraged to take action.

Several of us have been working on those measures, for example, highlighting the Treasury Department's financial report of the United States, which uses accrual accounting and which shows that the deficit last year was not 1.9 percent of GDP. It was closer to three or four percent of GDP.

But even that measure does not take into account some of the most important programs that we have in this country like Social Security and Medicare.

So in your testimony, you mentioned the unfunded liabilities of Social Security and Medicare. Does that mean that you count these as liabilities?

Mr. BERNANKE. Let me first start by agreeing with your basic thrust that the unified budget deficit has its value because it says some things about the current economy, but it is not a full measure of the fiscal obligations that are being taken on.

As I am sure you know, the Advisory Board to the Treasury has promoted this accrual accounting approach to the deficit, and that gives you the bigger number you mentioned. And what they have done there is they have included not only the current spending, but they have, you know, taken on board the accrual of obligations to future pensions for federal government workers and veterans and the like, and those are legal obligations that any private company would include as part of its liability assessment in a given year.

The FASB is currently looking at whether to include a measure of the accrued liabilities to Social Security and Medicare as part of a broader measure yet of the accrual-based deficit and there they are confronting exactly, I think, the issue that you are talking about.

First of all, projecting those liabilities, of course, is difficult, but that does not stop accountants usually from trying to incorporate them.

The other question is whether or not there are legal liabilities in the sense that, of course, Congress can and has in the past changed benefit schedules from what had originally been planned. And so in that sense, perhaps these are not liabilities in the strict legal sense of the word. And that is part of the reason why they have not been incorporated in these accrual measures.

But I would say that there certainly is a sense that if there is no change in policy that automatically we will be incurring these large entitlement costs and our short-term unified budget deficit does not in any way reflect the fact that as we move along, we are getting older, and those obligations, at least implicit obligations, are getting larger and larger.

Mr. COOPER. Thank you.

In my short time remaining, it seems to me to be the biggest single disconnect in all of American politics, the fact that all of us on both sides of the aisle praise these programs and promise benefits. And, yet, when you actually look at the budget of the United States and the common deficit measure, these entire programs are largely excluded, ignored.

So not only are these unfunded obligations or liabilities, they are also largely uncounted obligations. And in order for us to have a chance of delivering the benefits that we promised, we are going to have to start counting them. That is why I am so strong an advocate for these broader measures, so that we have a chance to fulfill the promises that all of us have made to our constituents.

But I thank you for your great service and your steady hand at the fed.

Mr. BERNANKE. Thank you.

Chairman SPRATT. Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman.

Chairman, thank you for being with us today. I am going to throw three questions at you and then give you all the time to answer them.

Number one, savings. I know other countries do this, but we lose a lot of savings time between zero and 18 or zero, date of birth, and when they enter the job market.

Would it not be a smart thing to do to set up some type of personal retirement account through incentives or whatever that would allow members, citizens to start some type of savings, give breaks if they add to it along? Something to think about there.

Number two, in your testimony, right at the end, you say if early—talking about entitlement spending, by the way—if early and meaningful action is not taken, the U.S. economy could be seriously weakened, and you go on. Of course, I know you are talking about Medicare and Medicaid.

Can we continue, question two, can we continue down the road of doing a little bit here and a little bit there? Are you talking about major course adjustments and do you not think or do you think that we need some type of overall national road map to say, hey, these are problems, we cannot do hit-and-miss operations anymore, we need a national goal that all of us can buy into and work on?

Last one, there is a direct correlation, I know you know, between the tax burdens and economic growth. Some people seem to think the average level is about 35 percent all government levels.

How close are we to that level right now when we look at state, local, federal, the whole nine yards? It is all yours.

Mr. BERNANKE. Thank you.

On savings for young people, obviously it would be great to get young people saving. There have been some proposals. Again, I am not going to try to address very specific proposals. But there have been proposals about giving money to children, you know, creating an account at the time that they are born.

I think it is a problem that kids do not know enough about saving. They do not know enough about money in general. The Federal Reserve is very interested in financial literacy, teaching that in the schools, trying to get kids involved in saving and understanding that. I do not have a magic bullet again, but I think that starting young and trying to broaden the base.

You know, there is a certain part of our population where these financial matters are just second nature, you know, but many people who do not really get exposed to them and find them difficult and mysterious and to their detriment. And to the extent that we could help people learn about how to save, how to budget, we are doing a great service.

On the size of the entitlements, these are very large deficits. It is hard to find good ways to measure it. The trustees have the present value of the infinite horizon deficit for Medicare at about $72 trillion, to give you an idea of the enormous amount of money that is.

That does not include the fact that we already have a baseline level of finance in the budget for Medicare. If you take that out, it is still about $54 trillion. So these are enormous amounts of money.

It is important, I think, to note that the Medicare part is probably four or five times as big as the Social Security part. So as difficult as it has been to address Social Security, Medicare is a bigger problem.

And I do think we are going to have to, you know, think hard about the structure of those programs. And in the case of Medicare, think also about the healthcare sector more generally and the cost that it is creating.

It was implicit in my comment about looking at multiple indicators that to the extent that Congress can look beyond the next couple of years and perhaps have some kind of plan or some kind of, you know, benchmarks moving forward that that might be quite useful.

In particular, this is just going to get harder politically because you are going to get to the point where you will be affecting the

benefits of people who are, you know, close to retirement. If you make changes now that take place decades in the future, you know, you will not be affecting anybody's benefits who are either retired or close to retirement. And you can phase them in gradually. You can give people time to plan. So I think working well in advance is a much better way to deal with this.

On taxes, the federal share of GDP and revenues is about 18 and a half percent. For state and local governments, it is nine to ten percent. So we are somewhere in the 27, 28 percent range right now.

I do not know if there is a magic number where economic growth is affected, but it is true that on the revenue side, that higher taxes do have disincentive effects and do have some adverse effects on the economy. And the question, of course, you always have to ask is whether the spending programs have enough benefits to outweigh those costs to the economy.

Mr. BARRETT. Thank you.

Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Allen.

Mr. ALLEN. Mr. Chairman, thank you for being here. I have a quick comment and then I want to pursue this same line.

You conclude your testimony by saying decisions the Congress will face will not be easy or simple, but the benefits of placing the budget on a path that is both sustainable and meets the nation's long-run needs would be substantial.

It seems to me we were once on a path, though not perfect and not likely to grapple with all the problems of Medicare and Medicaid, it was a lot closer to that goal than we are today. And that was the last four years of the 1990s when we were running surpluses and in much better fiscal condition than we are today. And I think the policies that drove us in the 1990s are worth looking at again.

But my question really goes back to these healthcare issues. This is the Budget Committee. We deal with the federal budget. But you just said that with respect to Medicare, we need to look at healthcare more generally.

And most of the health policy experts I know would say that the cost drivers in Medicare and Medicaid are pretty much the cost drivers in the private commercial system as well, and that if you look at other countries, we have essentially, you know, one of the least cost-effective systems in the developed world.

So the question is probably, how much does it matter whether we pay for healthcare through the public sector or the private sector?

Imagine this. Imagine that we could take care of our small businesses who are having trouble providing coverage, to help Ford and GM and other large businesses that are finding it hard to compete in the global economy, suppose we develop a simpler healthcare system which covered more people but held down the cost.

If more of that were paid through the public sector, would it make—and I am not asking you to evaluate a particular plan—but would it make any real difference, because if you had a cheaper system with essentially more money available in the private sector for investment but more of the healthcare sector being taken care

of through the public programs, you would wind up with a more cost-efficient system overall but a little larger public component.

Do you have any reason to think that would have a material effect, positive or negative, on our global competitiveness?

Mr. BERNANKE. Congressman, I have many views about the healthcare sector, and I hope you do not expect me to give them all——

Mr. ALLEN. I do not. I do not.

Mr. BERNANKE [continuing]. In a minute or two. We have a very good healthcare system. Let me just say that. And we have the most technologically-advanced system in the world. And on average, we get our money's worth in the sense that studies have shown that the benefits in terms of reduced mortality from heart attacks and so on, you know, that the cost, you know, is justified.

Having said that, I think we could be much more efficient. I think we could get more or less the same health benefits at lower cost. And there are a number of issues there. There is health IT. There is transparency. There is a whole variety of things that we could probably do.

One of the issues that is important, I think, is that our system promotes perhaps overuse of insurance by some people. I mean, we have some people with no insurance and we have some people who have first dollar insurance. And first dollar insurance has the problem that no one cares about the cost. It is going to generate higher cost and people are going to use high technology solutions which may not be essentially necessary.

So I think there are ways that we could go about making the system more efficient, reducing costs, and rationalizing the healthcare system overall. And I think independent of the fiscal situation, that is just very important to do and we should be trying to do that.

In terms of the government's role, you can point to a few things like potentially reduced administrative costs. I would raise the concern about a system where the middle class person pays taxes for services received by middle class people because by doing that, you are raising the tax burden, the overall tax burden, and, therefore, the marginal tax rate. And that is going to have incentive effects and efficiency effects on the economy.

So I think in terms of the efficiency impact, I think you are better off focusing on those with lower incomes and those who are sick who need more help and not necessarily using taxes to pay for the average person's healthcare.

Chairman SPRATT. Mr. Garrett.

Mr. GARRETT. Thank you. Thank you, Mr. Chairman and Mr. Chairman.

Your testimony is much like testimony of other experts that we have had before this Committee in the last month and a half, and that is it is all ominous and discouraging. I am sure well-intended though. Ominous in the sense of the problem that lays before us and that is not just a short-term, but it is a long-term one.

And in dealing with the problem, it seems very basic then that you either have to address—some of your suggestions are on the spending side of the equation or very simply on the revenue side of the equation.

And so I am just going to take one little narrow approach just for a minute here. If we look in part to the revenue side of the equation, there are some from both sides of the aisle, mainly I will say the other side of the aisle, that suggest that we solve that problem by raising our taxes. And I am not going to give you a specific tax right here.

But basic economic thought would be, correct me if I am wrong, that if we raise taxes on one sector, for example, the business sector, at the end of the day, businesses do not, in essence, pay taxes. It is the consumer who ends up buying that product that ends up actually paying that tax, whether that is a rich consumer or poor consumer.

Is that a correct basic economic thought of how taxes get flowed down to the bottom line?

Mr. BERNANKE. Businesses are not people. Corporations are fictional people but not real people. And somebody, either the shareholders, the customers, the workers, or somebody, is going to bear the ultimate burden, the ultimate incidence of taxes.

Mr. GARRETT. One of the questions here was with regard to the housing market and the huge effect that it plays. And on the subprime market, there was a question already. And somewhere I have here an article that talks about that. Well, the headline in this paper was "U.S. Mortgage Crisis Goes Into A Meltdown."

And they had the head of the Pacific Capital said the sector was in an unstoppable meltdown that is, "It is a self-perpetuating spiral. As subprime companies tighten lending, they create even more defaults."

And one of the Governors of the Board, Governor Susan Schmidt Bies, stated that although she did not see much total large impact, she did say that there are "hidden problems caused by sellers pulling property off the market. The percentage of homes where nobody is living in them is at a record level so the potential for inventory correction is still very high," she said.

With that all being said, is there an additional problem that we could see if we took action now looking at either that market or the overall market and said to address these mandatory problems, Social Security, et cetera, besides just the ones you talked about, to address that problem from a revenue side, we are going to raise taxes at least on that sector? Could that exacerbate the problem on the housing sector?

Mr. BERNANKE. I would have to know more about what taxes you have in mind. If you raise taxes on housing, you would reduce the price of housing generally speaking.

I guess I would just want to respond to your initial comments and say that we are concerned about the subprime mortgage sector. We are watching it very carefully. We think there has been some bad underwriting in that sector.

We have attempted to provide some guidance to lenders about proper procedures for underwriting and disclosing subprime loans. And we are going to provide additional guidance, I believe soon. So that is a significant problem. And there are obviously some financial losses associated with it.

But as Governor Bies said and as I said earlier, so far, there seems to be no indication that those problems are spreading either

into the broader financial markets or that they are having significant effects on housing or housing demand in the broader economy. But we will be watching that obviously very carefully.

Mr. GARRETT. Okay. And my last question is on that sector. If we were to impose a tax just on the—not the middle class, but the first time entering market in the housing market, specifically those markets that is where the securities are picked up through the GSEs, and that is where the market goes into, the mortgages going into, if we were to place a tax on that sector of the market where we are already having problems, such as a tax on the mortgages, could that exacerbate the problem then?

Mr. BERNANKE. If there is a tax on the new home buyer or on mortgage interest, naturally it would affect behavior.

Mr. GARRETT. And, again, whether it is directly on me the borrower going to the bank and have a tax just on me or the overall GSE, wherever you place the tax, that eventually——

Mr. BERNANKE. I see. If you are talking about the GSE situation, I understand. I think it would depend. I think there is an interesting and serious question about, as I mentioned before, the incidence of a tax on a business goes to lots of different people. It goes to shareholders. It goes to workers. It goes to customers and so on.

And so I think one of the important questions in addressing the issue you are talking about would be what is the incidence of that tax. Is it mostly on the shareholders? Would it affect the cost of mortgages? Would it affect something else? So I think that is the question one would have to address.

Mr. GARRETT. Okay. So I have 53 seconds left. I will try to pin that down a little bit more.

At the end of the day, even if initially the burden is placed on the shareholders, that leads to the natural inclination of people not to want to invest so heavily in that company or entity no matter which one it is. And eventually that raises the cost of doing business for that particular entity. They may have to borrow at other rates, at higher levels.

So eventually, although the shareholders may actually pay the cost today, that corporation ends up having to bear the burden itself. But as you said, they do not bear burdens. They pass it on to somebody else. So today the shareholder pays it.

But eventually if higher interest rates that they have to charge again goes down to the ultimate user, and that is the consumer; is that not correct?

Mr. BERNANKE. Well, in the case of the GSEs, as you know, although there is no official government guarantee behind the GSEs, there is a perception in the market that there is such a guarantee. And as a result, the interest rate at which GSEs borrow is just a little bit above the Treasury rate.

I would think that until such time as there is a change in the views of the financial market about this implicit government guarantee that that interest that GSEs pay will continue to be pretty close to the Treasury rate.

Mr. GARRETT. Interesting. Thank you.

Chairman SPRATT. Ms. Schwartz.

Ms. SCHWARTZ. Thank you, Mr. Chairman, and appreciate the opportunity to follow-up.

Some of my colleagues on both sides of the aisle have talked about the concern about household debt and the relationship to the housing market. And I think that for many Americans, they sort of do not necessarily see the cumulative effect of each household increasingly borrowing to meet basic obligations. I mean, sort of meeting the pattern that the federal government is doing the same thing. You know, we are borrowing to meet basic obligations.

What is happening, and I wanted you to comment? You talked a bit about both risky behavior and maybe some of the subprime market. But even more middle class folks are now using the one big asset they have, maybe the only real long-term asset they have, their home, to borrow against in order to continue spending.

Now, some of them may be outside of their control a little bit in terms of meeting basic obligations, healthcare costs, obviously other kinds of costs that they have.

But could you speak really a little bit more specifically about how you see either the risky behavior on the part of lenders or maybe the risky behavior on the part of borrowers, and this is really every-day Americans who are trying to meet their obligations, who have stopped saving and are not only using all their dollars that they have to meet obligations, but are now refinancing their homes, they are consolidating credit card debt and other kinds of debt, maybe even educational debt, to borrow against, as I say, that one asset, which is seeing an increase?

Now, of course, the bubble is over in housing. We may not actually see the house even be worth it in the future. So they are borrowing against their only asset.

And to what point does that put that family at greater risk long term in not planning for a downturn personally, but also the effect it has more broadly on the economy not being able to access that capital that used to be put into savings potentially, either for themselves or so it would be available in the marketplace?

Mr. BERNANKE. Congresswoman, that is a very interesting question. With respect to an individual family, it would depend a lot on their individual financial circumstances. There are people who have owned their homes for a long time and they have quite a bit of equity in the home. And in that case, it probably makes sense to consolidate debt and to pay for college and so on from home equity. It is an important part of wealth.

There are others who have very little equity share and they are putting themselves in a situation where they are not able to refinance and they could end up losing their home. So it depends very much on the individual circumstance.

I think, you know, it is good that markets have become more sophisticated and more flexible so that people do have the flexibility to use money from their home under, you know, appropriate circumstances. But it does probably contribute to a lower saving rate, at least over short periods of time.

The increases in people's wealth associated with higher house prices or higher stock prices are not counted as part of the national saving rate or individual household saving. So when you do have a run-up in house prices, for example, and people let their houses do their saving for them, then that is one reason why the current saving out of current income is low, and that has the consequence

that we talked about before, that we have to then borrow for new investment. We have to borrow from abroad or pay higher interest rates.

So my expectation, I mean, one effect potentially of the flattening out of prices in the housing market may be if people are therefore less able to use extracted equity, they may actually begin to save more out of current income. And that is one reason to think that saving out of current income may rise a bit over the next couple of years.

Ms. SCHWARTZ. Is there more that we could do, either we, you or we could do in helping to have most Americans understand that in a way?

Now, some of what you are suggesting might just be market-driven people understand they cannot borrow against their house, but we are doing the same thing. We are sort of by example, federal government is borrowing to meet obligations.

We are suggesting and there is a lot of market out there that is suggesting consolidate your debt. Again, that may be a good thing. But over time, individual families are not protecting themselves and there will be a consequence to them.

And could you be more specific in the few seconds left about what else we could be doing either by example or to educate the American family about how that may not be the best even if the market is telling them they can do it?

Mr. BERNANKE. Well, there is one important difference between the hypothetical family than the U.S. government. The hypothetical family is borrowing against an actual asset that they have. I mean, household wealth is still rising on net, net of debt. So it is not that the households are drawing down their debt in that sense.

Ms. SCHWARTZ. But it is a point well taken. The government is actually borrowing against——

Mr. BERNANKE. We are borrowing against future taxes essentially.

Ms. SCHWARTZ. And we are borrowing mostly from foreign governments at this point.

Mr. BERNANKE. Well, not directly, but indirectly, yes. On the individual family, I am again a strong advocate particularly for lower-income families, helping them through counseling, training, financial literacy, and so on, to understand better, you know, the complexities of finance, personal finance, so that they can live better lives in terms of saving and acquiring assets.

Ms. SCHWARTZ. And then we should learn by example from them.

Mr. BERNANKE. Yes, ma'am.

Ms. SCHWARTZ. Thank you.

Chairman SPRATT. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. And thank you for holding this hearing which I believe is probably one of the most important hearings we may have this year.

Chairman Bernanke, welcome. It is good to see you again.

If I could have chart number two pulled up please.

Mr. HENSARLING. Chairman, on page two of your testimony, you used the phrase that we are experiencing what seems likely to be the calm before the storm. You allude to the growth in the three

major entitlement programs and relate that to a percentage of GDP.

As I understand it, you were referring to CBO analysis and in that analysis, I believe you show that in 2006, Social Security, Medicare, and Medicaid totaled about 40 percent of federal expenditures or eight and a half percent of GDP, soon to increase to ten and three-quarters of GDP by 2017.

And eye-balling spending under CBO analysis over the long term, it appears that the budget will grow from roughly 20 percent of GDP if we do not reform current spending trends to roughly 30 percent by 2037 and approaching 40 percent, almost double, in about 40 years. I do not know if that is one or two generations.

My first question is, and I believe your numbers are based on CBO analysis, to the extent that you have looked at other analyses from OMB, from GAO, from Treasury, everybody who is in charge in the federal government of looking at long-term spending trends, is this an accurate analysis? Is there any significant disagreement of thought on these long-term spending trends?

Mr. BERNANKE. There is always some uncertainty because of just the difficulties of projecting far into the future. We are quite confident about the demographics. We know how that is going.

One issue which creates some uncertainty is how quickly medical costs are going to rise. The standard assumption, which is in the CBO analysis that I presented and is also in the Medicare Trustee's analysis, is that costs per beneficiary are going to grow at one percent faster than incomes, which creates, you know, higher and higher cost and is a big part of this.

Now, you could think of that as being pessimistic or optimistic. It is actually optimistic in the sense that historically, the last 25 years, the so-called excess cost growth has been about two and a half percent, much higher. So we are going to have to get some efficiencies in terms of our medical sector just to get down to that one percent cost growth.

Mr. HENSARLING. Using the CBO analysis on page five of your testimony, you have a footnote here. Assuming that we were agreed that we wish to balance the budget and it had to be done in one fell swoop, you allude to an analysis that if we took half the burden from tax increases and half from spending reductions that we would be looking at an 80 percent decrease, I believe, in discretionary spending relative to the baseline and an increase in nonpayroll taxes of 35 percent.

So would that seem to suggest that if we follow that model in one generation——

Mr. BERNANKE. He actually did it.

Mr. HENSARLING [continuing]. For all intents and purposes, we would have to increase taxes, nonpayroll taxes 35 percent just to have a federal government that consists of little besides Medicare, Medicaid, and Social Security? There may be no border patrol. There may be no U.S. Marines. There may be no Department of Education.

Mr. BERNANKE. Congressman, if I may, the simple arithmetic, in 2030, according to projections, the entitlement programs by themselves will be about 15 percent of GDP and interest on the national debt will be about four percent of GDP. So you add those things

together, you are already above the 18 and a half percent of GDP which we are currently receiving in revenues.

So if you wanted to balance the budget in that case without either changing entitlements or raising taxes, as you point out, you would have to eliminate the Defense Department and everything else that the government does.

Mr. HENSARLING. My time is about to run out. I would like to try to slip in one more question. Alluding to this chart up here, the debate in Congress today tends to be between that blue line and red line debating the wisdom of previous tax relief over the last few years.

Again, this is a CBO analysis. But to some extent, does that tend to suggest that we are debating how to mop up six inches of water in the stateroom of the Captain of the Titanic when we should be focused upon the gaping hole in the hull of the ship?

Mr. BERNANKE. I do not want to downplay the importance of near-term decisions that you are going to make both in terms of spending decisions and how to structure the tax code, how high taxes should be. Those are important decisions that are going to affect how our economy performs. And they are going to affect the near-term deficits as well.

But I think what that picture tells you is that, you know, you should probably think hard about going to the heart of the problem, and the heart of the problem is are the entitlement programs and those—you are not going to solve this problem by small budget cuts or small tax changes. You do have to think about these large obligations and, you know, how you want to deal with them.

Mr. HENSARLING. Thank you.

Chairman SPRATT. Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman, very much.

Welcome, Chairman Dr. Bernanke. Glad to have you here.

Mr. BERNANKE. Thank you.

Ms. KAPTUR. The first two items I want to mention would just be a reporting back from your staff to the Committee. I would like your staff to provide a complete list to us of which Wall Street firms are earning fees off the sale of the array of U.S. debt securities, to provide a list of which firms from 2000 to the present, and the amount that each has been paid annually by U.S. taxpayers for conducting those transactions. That is the first request.

Number two, based on your testimony, in order to help to create a savings consciousness in our country, particularly among the young, I would invite your cooperation and suggestions on how to create and promote a public debt postal savings stamp program to sell the debt to our own citizens, including our youth in small denominations, as the Japanese have done through their postal savings stamp system and Franklin Roosevelt created in this country during the 1930s. I would value your suggestions there.

I wanted to make a comment and then ask two questions. The basic theme that runs through my comment is that our capital markets have to be held accountable in solving some of the problems that we face in this nation and that our economy is in unchartered waters.

As you say, we have very high debt levels. Our public debt, according to your testimony, amounts to 37 percent of one year's

GDP. And if you add to that the fact that the trade deficit knocks off an additional point off that GDP, that is well over half of the growth that does not benefit economic investment in this country.

Our middle class is shrinking. I used to say that these conditions were resulting in the middle class running hard to stay in place. I now say the middle class is running harder but falling behind as reflected in their rising debt levels and net negative savings.

Factory workers in my district are working six days a week, ten hours a day, week after week, month after month, and we still see the hemorrhage of jobs. They are being told the reason for their predicament is that they are in a knowledge economy and they are falling behind because they are not smart enough or that the problem in your testimony is, well, the fact is we got too many people getting older. I beg to disagree.

I think what is happening is that capital investors have figured out how to make egregious profits by outsourcing jobs to very undemocratic places and then reimporting those goods here because our trade policy is snuffing out jobs and we have a tax policy that rewards it.

And we do not have a redistributed income policy that helps our people to keep up in view of what is going on. ExxonMobile, I guess, is my key example of where we are out of whack, out of sync.

So my two questions are, what do you think might happen to the market for U.S. debt securities if a foreign buyer like China or Japan were to sell off a significant portion of their holdings of U.S. debt securities?

And, number two, nearly 95 percent of recent issues of U.S. debt instruments have been purchased by foreign buyers. Why are they the purchasers rather than American investors?

Mr. BERNANKE. Well, on the first question, I should first point out that it is not in the interest of China or Japan to dump treasuries on the market. They themselves would suffer capital losses from doing that.

I do think if there were—and I should be very clear, I have no information or expectation this is going to happen—but if there were significant sales by foreign central banks, for example, that there would be some short-run effect on the market in terms of the currency and interest rates probably.

I think the longer-term effect would be somewhat less because the market would adjust. It is a liquid market. And the holdings of, say, China of U.S. debt securities, including both public and nonpublic, is only about five percent of the total credit market outstanding.

So obviously we are watching that very carefully. I do not see that as a major threat to our financial system or our economy.

I am sorry. The second question was?

Ms. KAPTUR. The second question is nearly 95 percent of recent issues of U.S. debt instruments have been purchased by foreign buyers. Why are they the purchasers rather than American investors?

Mr. BERNANKE. Well, a couple of reasons. One, as we talked about before, is that Americans are not saving that much, and you

have to save in order to buy assets. And so that is part of the problem.

The other is interestingly that Americans seem to have a stronger preference for equities and riskier investments than particularly foreign central banks. So at the time foreigners have been acquiring fixed income instruments like Treasury debt or GSE debt, a lot of American investors have been purchasing either domestic or foreign equity which pays a higher return, but is also riskier.

So there is a bit of diversification going on in both directions for investors. But, again, the low rate of saving is also a contributor to that.

Ms. KAPTUR. Doctor, could I just ask you on the first two requests I had for data on providing a list of those brokerage firms, can you provide that to the record?

Mr. BERNANKE. I am not certain that we can, but we will do our best.

[The information requested follows:]

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, DC, March 30, 2007.

Hon. MARCY KAPTUR,
House of Representatives, Washington, DC.

DEAR CONGRESSWOMAN: I am responding to a question that you posed during my testimony before the House Budget Committee on February 28. You asked for information regarding the fees paid to Wall Street firms for underwriting Treasury debt.

On further consideration following the hearing, it seemed to me that your question could be based on a misunderstanding of the Treasury's approach to issuing debt. Treasury debt is not issued through a process in which the underwriting firms earn specified fees for assisting with Treasury's debt placement. Rather, the Treasury issues marketable debt through a public auction process in which the highest bidders are awarded the securities being issued. (Some small investors also bid to receive securities at the interest rate set by the auction.) Such auctions are open not only to the twenty-one primary dealers firm but to all potential buyers, including other dealers, banks and other depository institutions, insurance companies, pension funds, mutual and hedge funds, and foreign investors. These auctions, like virtually all aspects of the Treasury securities markets, are highly competitive and transparent. The auction process helps ensure that the Treasury issues debt at the lowest possible cost to the taxpayer over time.

I hope this information is helpful. Please let me know if I can be of further assistance.

Sincerely,

BEN S. BERNANKE,
Chairman.

Ms. KAPTUR. And the fees that are being paid. Who would have that if the Federal Reserve——

Mr. BERNANKE. We deal directly with so-called primary dealers who are brokers who deal in the Treasury securities and will have some information. We collect some information about their operations and their income and so on. And we will check to see what we have and we will be in touch with your staff.

Ms. KAPTUR. Thank you.

I mean, you would expect to see Cantor Fitzgerald on that list; would you not? You would expect to see Goldman Sachs on that list; would you not?

Mr. BERNANKE. Yes.

Ms. KAPTUR. All right. We would be very interested in the fees.

And then secondly, on the question on the postal saving stamp program, could you perhaps provide a framework in which to suggest how that might be reinstituted in this country?

Mr. BERNANKE. Well, I am eager, as I said before, to try and promote saving behavior among young people, and there are many ways to do that. Making saving more accessible, making acquisition of assets more accessible would be one step in that direction. And, you know, I think it is worth looking at.

Ms. KAPTUR. Thank you.

Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman.

Thank you, Dr. Bernanke.

I have a couple of economic questions, then one relative to the savings. First on the economic question, as you stated, spending currently is 20.3 percent of GDP which is roughly equivalent to the average since 1960.

If as part of curing this long-term problem that government spending as a percent of GDP went up, what impact would that have on economic growth?

Mr. BERNANKE. If government spending as a share of GDP went up primarily in order to finance transfer payments, that is entitlement programs, and taxes would have to go up a comparable amount in order to have long-term budget balance, then depending on the nature of the taxes, presumably it would tend to create a dead-weight burden. It would tend to slow economic growth.

Mr. CAMPBELL. You have eloquently pointed out the problem of our snowball of accumulating spending and debt. If, big if, political if, we were to arrest that and basically balance the budget going forward, does carrying the existing national debt that we have, if we were to carry that over time, how big a drag is that on the economy and how big a problem is that, if we were not adding to it?

Mr. BERNANKE. If we were not adding to it, I think it would be a good stable situation. The 37 percent ratio of debt outstanding to GDP is actually lower than most other countries. Japan has a ratio of over 100 percent, for example.

So if we were staying at this point, it would be fine. The problem is that prospectively with the entitlements coming down the road, we are looking to go well over 100 percent in the next 25 years.

Mr. CAMPBELL. Right. But carrying that forward is not the great economic disaster if it is does not continue?

Mr. BERNANKE. No. No. I would say that the current level of debt, if there were no entitlement problem, which is an enormous if, would be not necessarily a problem. But it is the prospective increases that are a concern.

Mr. CAMPBELL. So putting those two questions together, if we were able to balance the budget, arrest the increase in debt, and keep the government spending and revenues at roughly the same kind of level that they are at today and have been historically, that would be a pretty good economic situation in terms of the government's contribution?

Mr. BERNANKE. Given what we are seeing in terms of the potential liabilities for entitlements, it would be an enormous improvement over the current situation.

Mr. CAMPBELL. The last question I have is relative to the savings and net worth. Now, I am from California. And as you mentioned, net worths are rising. Savings have not been.

It seems to me that people are consciously making the decision to put their net worth increase in places other than traditional savings as measured by the Fed or whomever, whether that be in the value of their house, equity in their house, or some other non-financial asset or whether that be in some retirement thing or stocks or some other financial asset.

And I would suggest that people are making those decisions because they believe that financially it is smarter to put their net worth in those sorts of assets rather than in traditional savings.

So my question to you is, why is the savings rate a problem if you agree, and maybe you do not, that that increase in net worth is not going into savings because people are making a rational economic decision which improves their financial stability or certainly they believe improves their net worth over time?

Mr. BERNANKE. To a large extent, it is a rational decision. If your stocks and your home value are going up a lot, then there is less need from your personal family perspective to save out of your current income.

I would just add parenthetically that what some people do is take money out of their home, for example, in order to invest it in other assets so as to diversify to some extent their overall portfolio.

From the national perspective, though, the problem is that increases in the value of homes, for example, do not constitute funds that are available to make new investments, for example, in capital equipment and so on.

And so in order to maintain our investment rate which includes construction of new homes as well as business capital investment, we have been forced to go abroad to the tune of about six, seven percent of GDP to finance that out of current flows of savings.

So from the individual family perspective, it is not irrational. I would——

Mr. CAMPBELL. Well, if I can then insert my last question before my time runs out, then are we not seeing here a disconnect between an individual family perspective making something that is perhaps best for them but may not be best from a national perspective and, if so, what could we do to align those two?

Mr. BERNANKE. Well, I would note first of all that the family with lots of equity that is making rational financial decisions, that is one group of people. That is not everybody. There are obviously some people who would be well served to increase their saving, increase their assets, be better off financially.

And the second comment I would make is that, apropos to the subject of this hearing, that a big negative influence on the national saving rate is budget deficits at the federal, state, and local level. And one very direct way to begin to increase national saving and in particular to create more resources available for current investment, current home construction is for the budget deficits to be reduced or for surpluses to increase.

Mr. CAMPBELL. Thank you, Dr. Bernanke.

And thank you, Mr. Chairman.

Mr. Becerra.

Mr. Doggett.

Mr. DOGGETT. Thank you. Thank you for being with us.

In your recent address in Omaha, you endorsed boosting national investment in education and training and cited specifically the work of the Federal Reserve Bank of Minneapolis and its findings of the higher returns from pre-kindergarten programs and other early childhood efforts and how that can help us achieve lower rates of social problems like teenage pregnancy and welfare dependency.

Why do you recommend investing in pre-k and does it appear to be one of the public policies with the best return?

Mr. BERNANKE. Well, I was referring to some very active research that has been done at the Federal Reserve Bank of Minneapolis and some policy work that is being done in Minnesota as well. And I was citing the research by Jim Heckman, who is a Nobel Prize winner, and others that this is a high return activity from a social perspective and from an individual perspective as well.

So I do think it is definitely a direction that might well we pay attention from the Congress.

Mr. DOGGETT. Thank you.

I am trying to balance this hearing and one that is happening at the same time in Ways and Means concerning climate change. And as you are well aware, an increasing number of responsible businesses are urging that we address the troubling increase in global temperatures, and fewer and fewer fit within that shrinking breed of climate change deniers.

Do you believe that the dynamic economy that you have described can absorb the cost of reasonable measures to address global warming and perhaps even expand clean energy and energy efficiency as a growth industry for our country?

Mr. BERNANKE. Well, let me say first obviously that I am not a scientist and I do not have an independent opinion about the magnitude of the problem, and I think very importantly I do not have an independent opinion about how severe or how large the effort would have to be if we were try to reduce emissions to levels of 20 years ago. I would imagine it would be a fairly significant cost associated with doing that.

So I hope that the scientists and the economists will get together and try and think together about, first of all, you know, how much effort is needed, how fast in terms of what makes sense for both the climate and for the economy.

And secondly, I think very importantly that, to the extent we agree, that we need to do something that we try to do it in ways that will minimize the impact on the economy. One way to do that, which is consistent with what you were saying, is government support for basic technology. I think that there are incentives for firms to develop applied technology. But at the basic research level, the government can provide some help, some resources.

And secondly, if, and, again, I am making no judgments about whether this should be done or not, if Congress were to decide to go forward with some kind of program, trying to use some mechanism like a cap and trade or market-based system that equalizes the cost of any given amount of carbon reduction across firms, across industries could allow a given amount of carbon reduction at lower cost. And obviously we should always be looking for ways

to reduce the cost of achieving any particular environmental objective.

Mr. DOGGETT. So a reasonable cap and trade system that tries to rely on the marketplace to address these issues is one approach that you think we should consider?

Mr. BERNANKE. I think relative, for example, to an approach that prescribes how much each particular company, each industry has to do that this would provide, again if Congress decides to go in this direction, it would allow a given amount of emission reduction to take place at lower overall cost to the economy.

Mr. DOGGETT. One last one. Some of the questions I have heard here this morning seem to suggest that we do not need to worry about revenues or tax shelters or tax savings or whether corporations are paying their fair share, that all we need to be concerned about is that grandma's Social Security check is too big.

And without minimizing our need to focus on entitlements and 2030, you are certainly not saying that as we look over the next few years of the budget we are developing that we do not need to consider both the revenue side as well as the expenditure side?

Mr. BERNANKE. No. It is the Congress' responsibility to look at all the options, and I am not going to take one side or the other, but I think that you should definitely consider all options and try to balance the costs and benefits of both sets of approaches.

Mr. DOGGETT. Thank you for your testimony and your important service.

Chairman SPRATT. Mr. Smith from Nebraska.

Mr. Tiberi.

Mr. TIBERI. Thank you, Mr. Chairman.

Chairman, can you tell us a little bit about your thoughts on, when we have seen the economic growth over the past several years higher than most economists have projected, when you look at that, what are your thoughts in terms of behavior? And you have talked about behavior with respect to our tax policy. What are your thoughts on how the cut in the capital gains tax and dividends have impacted that growth?

Mr. BERNANKE. It is frankly hard to assess the effects of one specific tax over a short period of time. From a longer-term perspective and looking strictly at the efficiency side of it, public finance economists generally, I would say, support keeping taxes on capital low because of the implications for saving and investments and other effects that might have.

But as always, you know, the Congress has to balance that against the revenue and progressivity aspects of the tax code as well.

Mr. TIBERI. But a general belief would be that keeping taxes on capital gains and dividends would encourage more savings and investment.

Mr. BERNANKE. That would be, I think, the view of most public finance economists, yes.

Mr. TIBERI. Thank you.

Again, thinking about economic growth, we have seen probably or I have seen, let me say, over the last year a bit of a backlash with respect to America's trade policy, with statements made by

some that America's trade policy, international trade policy has been negative to economic growth in America.

Can you share your thoughts on how international trade impacts our economic growth?

Mr. BERNANKE. I think that trade is very positive for growth. If you look around the world, countries that are open and actively trading show higher growth rates than those that are less open. So I think that for the economy as a whole, trade provides very substantial benefits.

Like new technologies, it also creates a certain amount of disruption and that is the kind of concern that would be useful to address in order to preserve the political support for open trade and capital flows, which I do believe are very beneficial to our economy both in the short run and the long run.

Mr. TIBERI. So in the long run, and I do not want to put words in your mouth, you believe that a trade policy which encourages fair trade between the United States and other countries abroad can be helpful to a broadening middle class?

Mr. BERNANKE. I do believe that it will provide broad benefits for the economy. Again, one of the problems here is that, like many things, that the benefits of trade are sometimes widely spread and, therefore, not quite so evident as the obvious costs of a shutdown of a mill or a factory.

And so we have to weigh those costs and benefits and in particular to again provide political support for continued integration with the world economy, continued openness. I do think we have to, you know, not ignore the dislocations that take place in particular communities, particular industries.

Mr. TIBERI. One final question, Mr. Chairman. Following up on Mr. Campbell's point about the savings rate, it appears to me that a family that rather than puts money in a savings account but quickly pays off their 30-year mortgage and has equity in a home, the current formula is not showing that positive benefit from that family's perspective of paying off a home. Yet, if they had not paid off the home and put that money in a savings account, it would have shown a different picture.

What can we do to paint a more accurate picture of America's savings?

Mr. BERNANKE. Well, actually, the increase in the value of the home due to a rising real estate market, for example, would show up in the Federal Reserve's measures of household wealth. So we do capture it in wealth measures as opposed to savings measures.

The example you gave of paying down the mortgage, if I put something aside from my paycheck in order to pay down the mortgage, that, in fact, gets captured as saving because that is part of current income which is not being consumed. It is being used to pay down debt. That would be part of saving.

Mr. TIBERI. Thank you.

Thank you, Mr. Chairman.

Chairman SPRATT. Ms. Hooley.

Ms. HOOLEY. Thank you, Mr. Chair, for being here today.

I just want to follow-up on a couple of questions. One was we were talking about capital gains tax cuts, whether that is increased savings or not.

Do we have any proof that that is increased savings? Do we know that that has had an impact on savings?

Mr. BERNANKE. Well, as I said, it is difficult to assess the effects of one small part of the tax package over a short period of time. Economists have looked at this and their concern is that when you tax capital income at a too high a rate that that will have effects over a long period of time because they really distort the decision about how much to consume today and how much to save, say, for retirement.

So there is sort of a theoretical case for this. But, frankly, you know, for a specific tax cut over a short period of time, it is hard to make an absolutely convincing empirical case.

Ms. HOOLEY. You said in a recent speech that the income of the top 90th percentile has grown over the last 27 years by 34 percent whereas if you are at the 10th percentile, it has grown four percent.

How do we close that gap?

Mr. BERNANKE. I think there are a few things that could be done, but I think by far the most important is to create a broader base of skills and knowledge and education.

There was earlier discussion about manufacturing. So it is true that as manufacturing industries have become much more productive that the number of assembly line workers has dropped. So that type of reasonably well-paying job for relatively low educated people is no longer available.

At the same time, though, the demand for high skilled workers in manufacturing who have not necessarily college degrees but who know how to operate complex equipment and so on has been soaring. In fact, manufacturers cannot find enough people with the kinds of skills they need.

So, again, I am not an education expert and I am afraid I cannot give you a long list of detailed recommendations, but I think broadly speaking what the issue is is helping those who have been left behind to acquire the skills they need to earn good wages in what is becoming a more and more technologically sophisticated economy.

Ms. HOOLEY. Well, as I see our economy changing, I see the need for more training and retraining of our workers as time goes on. And, yet, I look at the budget that was given to us and it has billion dollar cuts in employment and training programs. And I think that is where we make a mistake when we do not put money into that retraining program. I think our economy is better off when we do that.

Would you agree with that?

Mr. BERNANKE. One of the tough challenges with both education and training programs is being effective and doing a good job. And so if the budget involves a reallocation from some types of training activities to others, for example, I think it would be very important not just to look at the total dollar number but to see are we using programs that are known to work and that are effective because the total dollar input is not as important as what is the output on the other side in terms of skills acquired.

Ms. HOOLEY. I am going to ask you a question that has not been asked, and that was if you were in a class of fifth graders, how

would you explain to them the consequences of our national debt and deficit and how that is going to impact their lives, and what happens when they do not have a savings? So what would you say to that fifth grade class?

Mr. BERNANKE. I would say that our economy needs machines and new factories and new buildings and so on in order for us to have a strong and growing economy. If the government does not cover all those expenses, it has to take out the money that would otherwise be used to build those machines, those factories, those office buildings, all those things that make the economy strong, and give them the opportunities when they grow up to have well-paying, productive jobs. That probably would not work for a fifth grader, but that is about as close as I can get.

Ms. HOOLEY. That is okay. Thank you for your time.

Chairman SPRATT. Mr. Alexander.

Mr. ALEXANDER. Thank you, sir.

Mr. Chairman, good morning still.

One of the ladies earlier said something about a stamp program under the Roosevelt's Administration to help stimulate growth. But is it not true that President Roosevelt used some of the Social Security funds to finance the new deal?

Mr. BERNANKE. Well, Social Security was tiny. It was just beginning essentially in the 1930s.

Mr. ALEXANDER. Well, it was tiny, but the pay-outs were tiny, but——

Mr. BERNANKE. Well, it is true that the Social Security has always been primarily a pay-as-you-go system which means that the payroll taxes that are collected have not been invested in real capital. They have either gone into holding government debt or otherwise been used on benefits.

Mr. ALEXANDER. Okay. When we are talking about the entitlement programs, a lot more money coming out of those programs today than it has been in the past and, of course, a lot more money going into those programs.

But on a percentage basis, how much difference is it today percentage going in and percentage coming out than it was 20 years ago?

Mr. BERNANKE. I might not have your question exactly right. In terms of the flow of in and out, currently, as you know, the Social Security system is running a surplus, even forgetting about interest on the trust fund. The total benefits being paid are about four and a quarter percent of GDP and the total payroll taxes being collected are about five percent of GDP.

So that is three-quarters of a percent GDP contribution to the unified budget deficit not counting the interest being earned on the trust fund. So the Social Security fund is still in surplus now and is reducing the unified budget deficit.

Mr. ALEXANDER. Okay. Going back a long way, I think 1965 is when President Johnson signed Medicare into law.

Mr. BERNANKE. Right.

Mr. ALEXANDER. At that time, I could have bought absolutely the best car on the lot for $4,000. And today we have a system that is spending that much or more for medical devices, motorized

wheelchairs or whatever, and I am not arguing that there is not a need for it, but I am just leading up to a question.

The amount of money that is being spent withdrawing from those entitlement programs now, how much of it is a decision by bureaucrats versus Congress? I mean, I do not know if it was a congressional act that said, okay, we will now start buying fancier wheelchairs for people that need it.

Mr. BERNANKE. Well, going back to history, there has been a big increase in the size of the entitlements even up to now. The total entitlement spending in the mid 1960s was about three percent of GDP and now it is greater than eight, eight to nine percent of GDP. So there has been a big increase.

The Congress is ultimately responsible, of course, for the spending plans. In some cases, they are put on somewhat automatic pilot, which is why they are called mandatory programs.

For example, the formula for calculating initial and subsequent Social Security benefits is in the law and then whatever wages and prices do, that determines how much the benefits actually are.

And similarly some of the medical expenditure is not directly controlled. It is set by the rules that Congress has created for defining those benefits. So there is an annual appropriation for the total spending on entitlements.

Mr. ALEXANDER. In other words, you are saying oftentimes the spending is not necessarily something advocated by Congress, it is just something that Congress did not stop when they had an opportunity to?

Mr. BERNANKE. Well, Congress created the structure and the rules and that is the consequence of those rules.

Mr. ALEXANDER. Thank you.

Chairman SPRATT. Thank you, sir.

Mr. Berry is not here.

Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Chairman Bernanke, thank you for being here today and for your service to our country.

I printed off just before I came over here from the U.S. Treasury web site a document that shows major foreign holders of Treasury securities of our country, and it shows Japan as of December 2006 held $644 billion; China, mainland China, $349 billion; United Kingdom, $239 billion; and even Mexico had $34 billion in holdings for a total—I did not read off all the countries—but for a total, according to this document, of $2,223,000,000,000. Does that sound correct, sir?

Mr. BERNANKE. I think that is the total of international reserves. There might be more in private hands.

Mr. MOORE. Okay. But I am talking about——

Mr. BERNANKE. That sounds about right.

Mr. MOORE. Okay. And I heard your answer to Ms. Kaptur's question about what if these countries that hold our debt decided they did not want to hold it anymore for whatever reason, because of our deficits, because of our trade deficits or budget deficits or trade deficits, and decided they wanted to not hold these anymore.

And I heard you say I do not think that will happen, and I hope you are right. But sometimes we are not right. Sometimes we are wrong.

And if these foreign countries decided for whatever reason they did not want to hold our debt in the future, what would be the impact? What would you expect to be the impact in this country?

Mr. BERNANKE. Well, it would be disruptive in the debt markets in the short run. It would cause, for example, an increase in interest rates.

As I said before, I think in the longer term, the effects would be somewhat less because besides the Treasury debt, there is many other forms of corporate and GSE and other debt that is available as part of this broad fixed interest market.

I think it should be noted that the Federal Reserve could be of assistance in that situation. If interest rates went up and slowed U.S. economic growth, for example, the Federal Reserve could respond by using monetary policy and that would have some benefits.

I want to make a distinction that the foreign central banks acquire U.S. assets because we do have very deep and liquid, safe financial markets and they find it in their own benefit to do so, not because they are doing us any kind of favor.

Mr. MOORE. I understand.

Mr. BERNANKE. And as I said, I think that they will be willing to hold that for some time. In the scenarios I have described, though, where 20, 25 years from now the debt and the deficits are so big as to create a tremendous burden, then the willingness of foreigners or even our domestic citizens at that point to hold government debt at reasonable interest rates would certainly be much affected.

Mr. MOORE. I understand. I just wanted to point out, though, that sometimes we are incorrect in our assessments and the Administration, in fact, projected that between 2001 and 2004, there would be a $1.28 trillion surplus which, in fact, turned out to be an $850 billion deficit.

So sometimes with the best intentions in the world and trying to be completely straight, we just are in error in our assessment; is that not correct?

Mr. BERNANKE. Yes, sir.

Mr. MOORE. Another question then, and I have got just a minute and a half left. What would you think, Chairman Bernanke, about—well, you said that the Social Security fund is still in surplus now, correct?

Mr. BERNANKE. The current flow of payroll taxes collected is still higher than the benefits being paid out.

Mr. MOORE. Right. What would you think about establishing a true Social Security Trust Fund, one that could not be used for any purpose except what it was intended for and that is to pay Social Security benefits?

Mr. BERNANKE. So currently we are shooting for a budget balance that includes the Social Security system.

Mr. MOORE. Yes, sir.

Mr. BERNANKE. If we were able to shoot for a budget balance that did not include the Social Security system and, therefore, was essentially buying down Treasury debt with that surplus, then

clearly that would be putting our long-term fiscal situation on a stronger footing.

Mr. MOORE. We talk about a Social Security Trust Fund. In fact, in the real sense, the legal sense of the word, there is not one because we spend Social Security money for a lot of other things, some good things and some things people might have questions about, is that not correct, even though we still do have as a government the liability and the obligation to make good on the Social Security money that was supposed to be in that fund; is that not correct?

Mr. BERNANKE. Well, the $2 trillion Social Security Trust Fund is an asset of the Social Security system and affects the benefits profile, for example, going forward. But the $2 trillion Social Security Trust Fund is not an asset of the government as a whole because every dollar that is owed Social Security is a dollar that the government has to raise. So it is correct that from the government's perspective or from society's perspective, it does not reflect any real assets like capital or equipment.

Mr. MOORE. Thank you, sir.

Chairman SPRATT. Mr. McHenry.

Mr. MCHENRY. Thank you, Mr. Chairman.

Great to be with two of my neighbors to the south, Chairman Spratt from South Carolina and Chairman Bernanke from South Carolina. It is a pleasure to be with you all.

I wanted to follow-up on Mr. Tiberi's question about unlocking the potential of capital and the free movement of capital by reducing capital gains tax rates.

At the time we reduced the capital gains tax rate for individuals, we did not reduce the corporate capital gains tax rate, which now stands at 35 percent.

In terms of unlocking the potential of capital to move freely and to see its highest and best use, would it be appropriate to look at that, reducing the corporate capital gains tax rate?

Mr. BERNANKE. Well, specifically one of the advantages of, again from specifically an efficiency perspective, of keeping the dividend tax rate low is that it allows firms to pay out dividends without tax penalty and that money then gets recirculated in the capital markets and may find better uses than if it is in some sense trapped in the corporation. So that is one of the benefits from an efficiency perspective of low dividend tax rates.

Mr. MCHENRY. But in terms of corporate capital gains.

Mr. BERNANKE. Corporate capital gains are a part of the return to savings, return to investment. And for some of the reasons I gave earlier, economists tend to argue that moving towards taxing consumption and leaving saving to accumulate, not distorting saving decisions through taxes on saving behavior, leads to higher income in the longer run.

Mr. MCHENRY. All right. Chairman, you also spoke about whatever the size the government is chosen to be, tax rates must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run.

I know you have spoken about this before. But in terms of entitlement reform, at what point does our inaction as a Congress have a negative effect on the economy, meaning our inaction to achieve

entitlement reform? At what point does that actually become a drag? Is that 2008?

Mr. BERNANKE. I do not think there is a magic point. But the further this goes without any action, the bigger the current deficits are going to get which is going to draw capital out of more productive uses like capital investment or, alternatively, increase our obligations to foreigners. And, moreover, the further along we get, the harder and more painful it is going to be to try and adjust the budget in order to stop the accumulation of debt.

So it is really a two-sided aspect which is that it is true that we are not feeling a lot of pain at the moment from deficits, which makes it harder, I understand, politically to take action, because the benefits and costs of this are further down the road.

On the other hand, as I said, by acting now, we can at lower cost and with greater notice, we can make changes to programs that will take effect ten, fifteen, twenty, twenty-five years from now. And in that respect, we can do what we need to do or you can do what you need to do without immediate impact or without affecting those people who are already retired, who are near retirement, and who would perhaps justifiably feel that they were not getting what they had been promised if you were to affect their benefits.

Mr. MCHENRY. I know there are a number of discussions going on in the Congress right now about entitlement reform and, in essence, creating a commission to look at all the entitlement programs, all the mandatory spending programs, to look at ways to reform them.

And I wanted to ask you if you would be willing to comment on those ideas for maybe a BRAC like, BRAC style commission to review policy prescriptions and have that sent back to the Congress for a simple up or down vote.

Mr. BERNANKE. I am reluctant to endorse or comment on specific budgetary measures or similar measures as you describe. However, I do think that trying to focus Congress on the longer term and emphasizing the urgency of beginning to take action is highly desirable and whatever methods achieve that objective would be very good to undertake.

Mr. MCHENRY. Thank you, Chairman.

Chairman SPRATT. Mr. Berry.

Mr. BERRY. Thank you, Mr. Chairman.

Thank you, Mr. Chairman, for being here.

The United States Congress almost all the time is in this debate about taxes and tax cuts are good and tax increases are bad and so on and so forth. And I think we all agree that the lower the taxes can be, the better it is.

Now, you have already said here today, I believe, that they need to be the same. Whatever your revenues are, they need to be the same as your expenditures.

Does the impact of a tax cut change if you make that policy change and it results in tax reductions, but to offset the loss of revenue, you borrow the money?

Mr. BERNANKE. Because taxes and spending have to be commensurate in the long run, if you cut taxes and lose revenue through that tax cut and you do not make any adjustments on the spending

side, then that tax cut will essentially have to be temporary. It will eventually have to come back up in order to finance the spending.

So in order to get the incentive benefits of a tax cut, you also have to look on the spending side and be willing to make equal cuts in spending.

Mr. BERRY. We have heard from any number of people that sometimes these tax cuts do result in an improved economy and sometimes they do not. Would you agree with that?

Mr. BERNANKE. Not all tax cuts are created equal. Some are more effective than others. And, again, tax cuts that are accompanied by spending restraint would be more effective than those which are not.

Mr. BERRY. And we have also heard over and over again, and I think it is obviously true, that Medicare and Social Security as they are structured today are unsustainable, that we have got a train wreck waiting to happen out there. It is not going to happen tomorrow, but it is a very serious matter to this country.

Would this nation be better off without those programs?

Mr. BERNANKE. I do not think anyone is seriously advocating eliminating those programs. I think the question is trying to look at how they work and make some judgments about are there ways that the cost can be reduced and, if not, and let me just say, if not, then making the tough decisions to raise taxes on the other side.

I mean, the main decision which Congress has to make is how big is the government going to be. And all I am saying is the laws of arithmetic have to apply. If you just decide to have a larger government, which is not illegitimate, you could well believe that the social services and the other benefits of government spending are worth it, then that is fine, but you just have to be willing to accept the higher taxes and the implications that might have for economic growth.

Mr. BERRY. But right now we are really not facing up to that and we are just kind of whistling past the graveyard.

Mr. BERNANKE. Yes, sir.

Mr. BERRY. And hoping that the tooth fairy comes and bails us out of this deal. Is that a correct assessment? I know that is mine, not yours, and I would not expect you to assign yourself to what I just said.

Mr. BERNANKE. I do not know about the metaphors there, Mr. Congressman, but I do think that Congress does, and I realize, as I said several times, this is not an easy task by any means, but Congress does need to begin to address these long-run fiscal imbalances.

Mr. BERRY. Thank you, sir.

Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

And thank you, Mr. Chairman, for your very edifying testimony. I wish every member would read it. I think it is very, very edifying.

You describe our budgetary situation as the calm before the storm and I think you very correctly identified the storm as being severe consequences for the economy if capital pools are drained, if the price of capital rises, if we continue a policy of borrowing our way to an illusionary prosperity.

One of the matrix that you discuss as a way of measuring our progress toward avoiding that storm or preparing for that storm is the idea of the measurement of the long-term solvency of entitlement programs, such as the long horizon present values of unfunded liabilities for Social Security and Medicare.

Do you think that there are benchmarks that the markets are going to express and manifest as to which benchmarks we have to hit on that issue? I will ask you the question another way.

My understanding is we are adding each year to the present value of those unfunded liabilities by failing to take action on entitlement reform, and we are also adding to it by failing to put away Social Security surpluses which could be saved for those forthcoming problems.

Do you think that the market will manifest a benchmark where if the unfunded liability grows too large and the time before the storm starts grows too short that the markets will begin to punish us with higher long-term interest rates and, if so, what would you think those benchmarks are both in terms of size of the unfunded liability and distance from the storm?

Mr. BERNANKE. I think it would be hard to give you exact numbers. Thus far, the Treasury market has very willingly financed the government. Real interest rates are low. They have not come up much.

I would think that concerns would begin to mount if the government got to the point where it was coming closer to one of these snowball situations where the accumulation of interest on the debt was adding to the deficit which was adding to the debt.

If that looked to be something that was inevitable and that it was becoming increasingly unlikely that the Congress was going to be able to address that, and, again, the closer you get to that, the harder it is, then I think capital markets would become concerned about it.

Mr. ANDREWS. We, as you know, deal in five-year budget windows in the resolutions that the Committee addresses.

Could you give us a perspective as to what the markets would regard as a successful five-year project that would either reduce the unfunded liabilities or at least let their rate of growth slow? Is there a target we should be shooting at in the five-year window?

Mr. BERNANKE. Well, as I indicated, you need multiple indicators, and I am not sure that the five-year window sufficiently captures the long-run imbalances. So it would be interesting to look at projections as we saw on the screen a while ago of the imbalance at ten, fifteen, twenty years down the road and steps that move in the direction of ensuring that those imbalances are being closed. And I think just moving in the right direction is important.

Mr. ANDREWS. Assuming that we were able to enact a budget resolution that during the five-year window stop the process of using the Social Security surplus and began to bank it or save it toward reducing this future unfunded liability by making it funded, would you regard that as a positive development?

Mr. BERNANKE. I think it would be extraordinarily difficult to move that far on budget surplus in a few years, within five years and——

Mr. ANDREWS. But if it were, would it be a positive development?

Mr. BERNANKE. Well, the Federal Reserve would have to offset the short-term spending effects of that with lower interest rates. But that would be——

Mr. ANDREWS. So you promised us lower interest rates if we do that? Is that what I just heard?

Mr. BERNANKE. If you do that, we will do our best. But what we would do is we would respond in such a way as to try and keep the economy at full employment.

Mr. ANDREWS. I understand.

Mr. BERNANKE. But I think if you can demonstrate a plan that seems plausible and make a down payment on it, if I may say so, that would be certainly the right direction. It would be reassuring.

Mr. ANDREWS. I think one of the imperative projects of this Committee is to define plausibility, and we need your input on that and those of other leaders.

And I thank you very much for your testimony and for answering my questions.

Mr. BERNANKE. Thank you.

Mr. ANDREWS. Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Etheridge.

Mr. ETHERIDGE. Thank you, Mr. Chairman.

Chairman, thank you for being here this morning and thank you for your time. This is an important issue and you have got a tough job. We appreciate the job you do.

Let me ask you a question. You touched on this in different ways and all of us sort of struggle with our own family incomes and what our debt ratio is to our assets, et cetera. But my question is, do deficits matter at the federal level?

Mr. BERNANKE. Yes, they matter because they are part of the process by which debt builds up, and that debt burden is going to affect our children and grandchildren in two different ways.

First of all, it is going to be actually a debt that they have to do something about paying off, number one. But, number two, it is going to drain capital from the construction of new machines, new factories, and the like, or increase our debt to foreigners so that when that time comes to pay off that interest, they are going to have a less vibrant economy, you know, to earn income from in order to do it.

So debt does matter because it is the process of accumulation of debt which creates the burden for the next generation.

Mr. ETHERIDGE. Thank you. I happen to agree. I just asked that question because Vice President Cheney has stated that deficits do not matter. And it is obvious they do not with some of the spending, but let me move to another question.

You were quoted earlier saying, and you touched on this a little earlier today, and you had said earlier this month really that policies that focus on education, job training, and skills and that facilitate job search and job mobility seem to me to be promising means by moving toward that goal, talking about expanding the economy, et cetera, making it bigger, making the pie much larger.

I assume you still stand by that statement.

Mr. BERNANKE. Yes, sir.

Mr. ETHERIDGE. Thank you.

I ask that question because, just so you will know, in my previous life, I was in business. Prior to that, I was State Superintendent of Schools for a few years. And I happen to believe that if you are going to make the pie larger as we look out with all the challenges or projections, we can change those projections by changing output, educational levels and productivity of workers and the value added of each worker to that, because you have been saying that.

Mr. BERNANKE. It will add to growth and it will also create more opportunities for people across the income spectrum.

Mr. ETHERIDGE. Change those dynamics. And I look at the budget that we are dealing with that the Administration sent over, and there are a whole lot of gaps as relates to job training and education and those investments that I think are long-term investments as we look at the out years.

And I would be interested again in your comments and any thoughts you could help us with as we are dealing with that because it seems to me that if you really want to change the dynamics, it is an investment versus and expenditure, and you invest in the future and you spend for today.

And I think your comments have indicated previously that if you invest in education today and monitor it and measure it, that will give you a reward down the road if you do it right.

Mr. BERNANKE. If you do it right. I mean, the only caveat I would add is that the total budget line is not the only indicator of the commitment or the effort. It also has to be in programs that have shown to produce a good result.

Mr. ETHERIDGE. Well, let me just give you a couple examples before we get to your comments because I think it is important.

If we go back to World War II, the GI Bill was an investment. And men and women who were coming home and we know the results of that.

In the 1960s with the Sputnik, we got frightened. We put the "National Defense Act" in place, and the results of that was an infusion of capital that excited young men and women about a goal of going to the moon and it turned into a tremendous economic boom for this country. And we led the world in a host of ways.

We really need, I think, that kind of vision once again for our young people to challenge them academically to generate the kind of growth in opportunities we need.

And I think budgets are more than just numbers and figures. I think they are moral documents that speak to our visions, our hope for the future.

Mr. BERNANKE. I agree that a strong commitment to helping young people realize their potential is extremely important. There are many ways to address that. People disagree about the right way to do it. And I urge Congress to have a healthy debate about how best to foster learning, education, and skills among our whole population.

Mr. ETHERIDGE. Thank you. And thank you for your time.

Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Chairman, if you will indulge, Mr. Cooper has a question he would like to ask also, if you have the time. Thank you very much.

Mr. Cooper.

Mr. COOPER. Thank you again for your testimony.

You say toward the close of your testimony that if early and meaningful action is not taken implied by Congress, U.S. economy could be seriously weakened and future generations bearing must of the cost.

Our problem here is lighting a fire under some of our colleagues to get the tough decisions made. So one of the pieces of data that I have been using came from last summer's "Wall Street Journal." It was on page C6. It was from Standard & Poors, a leading credit rating agency.

And they projected, they did not predict, but they projected that the U.S. Treasury bond itself would lose its triple A credit rating if current trends continued by the year 2012.

Then they went on to project that by the year 2025, the U.S. Treasury bond would achieve junk bond status below investment grade. And that has been one of the more tangible warning signs because most folks kind of heard of S&P and think, well, gosh, that is not Democratic, that is not Republican, that is credit markets. And everyone has a sense that U.S. Treasury bond is the most important, most liquid instrument in the world.

So the prospect that we are literally destroying America's credit today by our inaction has helped light a few small fires, but still not enough to get folks going. So I appreciated your response to Rob Andrews' questions.

We, if we were to follow the President's budget, would be using $1.3 trillion worth of alleged Social Security surpluses to mask the true size of the deficit, because when the President brags that he is going to achieve a surplus in year five that he does not tell you that he would be doing that by borrowing that year about 230 or 40 billion dollars from Social Security.

So that really, if you look at all of our programs, including Social Security, we are still going to have a deficit in year five.

So how do we get a greater sense of urgency here? You are doing all that you can, but what can we be doing to get this problem solved early as you suggest?

Mr. BERNANKE. I think you need to consult with your colleagues and try to think about a plan. I think one of the—and, again, I am reluctant to get into congressional process of which I am certainly not an expert—but a good bit of the budgetary planning is about the relatively short run, and the question is whether Congress can define some matrix or benchmarks for progress on the long-term imbalance issue. If that were possible and if there were some will in Congress to try to meet those benchmarks, that would be a step in the right direction.

You are right. That is somewhat difficult because so far, the effects of the deficits are not evident to the average American. I mean, the average American does not know about the current account deficit and those sorts of things.

But, again, I think it is also an opportunity because we have enough lead time that we can make changes in programs that will not take effect until people who are now in their thirties and forties are approaching retirement and give them plenty of time to plan and adjust to those changes.

Mr. COOPER. I thank you, Mr. Chairman.

Chairman SPRATT. Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman.

Mr. Chairman, thank you for being patient and wading through the different questions that we have all asked you.

I want to go back to something that I know you have talked about quite a bit today and in other days and that is how deficits do matter.

And I think to underscore that, it is important to point out that this year, we are paying something close to the size of the identified deficit of $240 billion simply in interest payments on the national debt, which means we are getting nothing out of those $240 billion or so in payments on money we owe.

But I wanted to highlight and talk to you a little bit about what I think is not being explored well by all of us in government, certainly to the detriment of the American people, and that is the fact that while the President identifies our budget deficit for 2007 as being $244 billion, if it were not for the fact that we are using all the monies that we are collecting in the Social Security Trust Fund, all the extra dollars that are not being spent today for benefits to the Social Security recipients, the actual size of the deficit would be closer to $435 billion because there is about $190 billion in excess money that you today, I today, and every American who got up today to go to work is paying in the FICA tax for our Social Security and Medicare contributions.

I think it is unfortunate, and I think the Chairman tried to focus on this as well, that the American people do not quite understand what is going on and do not quite grasp why deficits do matter and what the consequences could be, not so much to us today, but to our children in the future.

And I am wondering if you can just comment a bit. This year in 2007, there are about $190 billion in surplus dollars in Social Security that you and I and everyone in America who works is contributing to the system with the expectation that it will be around when we retire. Next year, that amount rises to over $200 billion in surplus money. In 2009, it is about $218 billion estimated. In 2010, $230 billion. In 2011, $246 billion. In 2012, $255 billion in surplus monies in Social Security.

Each one of those amounts of surplus in each of those years, the President has in his budget that he has presented to us consumed every single cent of those monies, over a trillion dollars, in something other than Social Security. And you have mentioned how we need to have some fiscal discipline, how we have to get these deficits down. Is it wise for us—here is the question—is it wise for us knowing that we will have this liability, whether it is legal or otherwise, to the American people who today are contributing in FICA taxes for the Social Security benefits in the future, is it wise for us to not do more to explain to the American people that the size of the deficits are not 244 billion as the President identifies in his budget, but really $434 billion because we are masking the size of the deficit by using Social Security monies that ultimately, I think you and I would agree, we must commit to spend on Social Security in the future?

Mr. BERNANKE. Well, first, the unified budget deficit concept, which is what you are talking about, has been in use for a while. It is not a brand new thing. But you are right. It does have the property that essentially the surplus from each year is payroll taxes being used for other purposes.

I do not know how effective it would be, but I think probably some Americans do think that Social Security is like a 401k plan and that their contributions are being invested in real assets, which is, of course, not the case except in the very narrow sense that the trust fund has these IOUs in it. So I do think that would be something worth pointing out.

And I guess I could go even further and just note, as we had discussed earlier, that beyond the on budget deficit, which is what you are talking about, there is also the accrual deficit which adds to that the accrued obligations to, say, federal employee pensions and the like. And beyond that, it is the money that we are essentially owing each year as we get closer and closer to the demographic crunch.

So there are multiple measures of this. And I agree that the unified budget deficit is in some sense the least revealing in terms of long-term obligations.

Mr. BECERRA. And, Mr. Chairman, I would guarantee you that most Americans would say to you so you are using those monies that we are contributing extra to Social Security to help us take care of our troops, to make sure they are well armed, or to make sure that Katrina victims are being addressed or taken care of in New Orleans. I think they would say fine, that is a good investment.

But I wonder if most Americans would say that helping pay for the President's tax cuts which have benefitted very few of the majority of Americans who got up to work today because most of those tax cuts are directed towards folks who are probably in your income bracket and my income bracket and the upper echelons of our wealth, if the American public would say, well, that is really where I want to see my $190 billion in surplus Social Security funds going, recognizing that today we have got a budget deficit that is bigger than the whole $190 billion that Social Security is contributing to this budget.

And I think if we did a better job, all of us, in our respective roles of educating the public on the money that is out there, I think they would guide us in some good decisions and these long-term decisions that we have to make to try to corral these deficits that are growing very large and the entitlement spending that we have to at some point address as well.

So I thank you for being patient and being here and look forward to seeing you again at some point in the future.

Thank you, Mr. Chairman. I yield back.

Chairman SPRATT. Thank you, Mr. Becerra.

Mr. Chairman, you have been forthcoming as well as forebearing and we appreciate the efforts you have made to help eliminate the problems that line our path. They are daunting challenges, but they definitely need to be addressed. And you have helped issue a sobering call to action.

Thank you very much for your testimony today. We very much appreciate it.

Mr. BERNANKE. Thank you, Mr. Chairman.

[Whereupon, at 12:25 p.m., the Committee was adjourned.]